INTRODUCTION

A bank operates as a securities dealer when it underwrites, trades, or deals in securities. These activities may be administered in a separately identifiable trading department or incorporated within the overall treasury department. The organizational structure will generally be a function of the level of activity and the importance of the activity as a product line. If a repetitive pattern of short-term purchases and sales demonstrates that the bank holds itself out to other dealers or investors as a securities dealer, the bank is trading, regardless of what department or section of the bank is engaged in the activity.

The authority under which a bank may engage in securities trading and underwriting is found in section 5136 of the Revised Statutes (12 USC 24). That authority is restricted by limitations on the percentage holding of classes of securities as found in 12 CFR 1.3. This regulation allows banks to deal, underwrite, purchase, and sell type I securities without limit, and type II securities subject to a limit of 10 percent of capital and unimpaired surplus per issue. Banks are prohibited from underwriting or dealing in type III securities for their own accounts. Refer to section 2020.1, ‘‘Acquisition and Management of Nontrading Securities and Derivative Instruments,’’ for further information on types I, II, and III securities.

Banks are involved in three major types of securities transactions. First, the bank, acting as broker, buys and sells securities on behalf of a customer. These are agency transactions in which the agent (bank) assumes no substantial risk and is compensated by a prearranged commission or fee. A second type of securities transaction frequently executed by banks is a ‘‘riskless’’ principal trade. Upon the order of an investor, the dealer buys (or sells) securities through its own account, with the purchase and sale originating almost simultaneously. Because of the brief amount of time the security is held in the dealer’s own account, exposure to market risks is limited. Profits result from dealer-initiated mark-up (the difference between the purchase and sale prices). Finally, as a dealer, the bank buys and sells securities for its own account. This is termed a principal transaction because the bank is acting as a principal, buying or selling qualified securities through its own inventory and absorbing whatever market gain or loss is made on the transaction.

The volume of bank dealer activity and the dealers’ capacity in the transaction are critical to an examiner’s assessment regarding the examination scope and the required examiner resources and expertise. Dealers engaging primarily in agency or riskless-principal transactions are merely accommodating customers’ investment needs. Market risk will be nominal and the key examination concern will be operational risk and efficiency. Active dealers generally carry larger inventory positions and may engage in some degree of proprietary trading. Their market-risk profile may be moderate to high.

Bank dealers’ securities transactions involve customers and other securities dealers. The word customer, as used in this section, means an investor. Correspondent banks purchasing securities for an investment account would also be considered a customer. Transactions with other dealers are not considered customer transactions unless the dealer is buying or selling for investment purposes.

The following subsections include general descriptions of significant areas of bank trading and underwriting activities. Foreign exchange is covered in detail in the ‘‘International’’ section of this manual. Additional bank dealer activities, particularly in derivative products, are extensively covered in the *Trading Activities Manual*. In addition, many money-center banks and larger regional banks have transferred dealing activities to separately capitalized holding company subsidiaries (known as section 20 affiliates). The *Bank Holding Company Supervision Manual* contains a separate section on nonbank subsidiaries engaged in underwriting and dealing in bank-ineligible securities. These subsidiaries are separately reviewed as part of bank holding company inspections.

OVERVIEW OF RISK

For bank dealer activities, risk is generally defined as the potential for loss on an instrument or portfolio. Significant risk can also arise from operational weakness and inadequate controls. Risk management is the process by which managers identify, assess, and control all risks associated with a financial institution’s activities. The increasing complexity of the financial industry and the range of financial instruments banks use have made risk management more difficult to accomplish and evaluate.

The four fundamental elements for evaluating the risk-management process for bank dealer activities are—

- active board and management oversight,
- adequate risk-management policies and limits,
- appropriate risk measurement and management information systems, and
- comprehensive internal controls and audit procedures.

For risk management to be effective, an institution's board and senior management must be active participants in the process. They must ensure that adequate policies and risk-tolerance limits are developed for managing the risk in bank dealer activities, and they must understand, review, and approve these limits across all established product lines. For policies and limits to be effective and meaningful, risk measures, reports, and management information systems must provide management and the board with the information and analysis necessary to make timely and appropriate responses to changing conditions. Risk management must also be supported by comprehensive internal controls and audit procedures that provide appropriate checks and balances to maintain an ongoing process of identifying any emerging weaknesses in an institution's management of risk.[1] At a minimum, the effectiveness of the institution's policies, limits, reporting systems, and internal controls must be reviewed annually.

In assessing the adequacy of these elements at individual institutions, examiners should consider the nature and volume of a bank's dealer activities and its overall approach toward managing the various types of risks involved. The sophistication or complexity of policies and procedures used to manage risk depends on the bank dealer's chosen products, activities, and lines of business. Accordingly, examiners should expect risk-management activities to differ among institutions.

As a financial institution's product offerings and geographic scope expand, examiners must review the risk-management process not only by business line, but on a global, consolidated basis. In more sophisticated institutions, the role of risk management is to identify the risks associated with particular business activities and to aggregate summary data into generic components, ultimately allowing exposures to be evaluated on a common basis. This methodology enables institutions to manage risks by portfolio and to consider exposures in relationship to the institution's global strategy and risk tolerance.

A review of the global organization may reveal risk concentrations that are not readily identifiable from a limited, stand-alone evaluation of a branch, agency, Edge Act institution, nonbank subsidiary, or head office. Consolidated risk management also allows the institution to identify, measure, and control its risks, while giving necessary consideration to the breakdown of exposure by legal entity. Sometimes, if applicable rules and laws allow, identified risks at a branch or subsidiary may be offset by exposures at another related institution. However, risk management across separate entities must be done in a way that is consistent with the authorities granted to each entity. Some financial institutions and their subsidiaries may not be permitted to hold, trade, deal, or underwrite certain types of financial instruments unless they have received special regulatory approval. Examiners should ensure that a financial institution only engages in those activities for which it has received regulatory approval. Furthermore, examiners should verify that the activities are conducted in accordance with any Board conditions or commitments attached to the regulatory approval.

Ideally, an institution should be able to identify its relevant generic risks and should have measurement systems in place to quantify and control these risks. While it is recognized that not all institutions have an integrated risk-management system that aggregates all business activities, the ideal management tool would incorporate a common measurement denominator. Risk-management methodologies in the marketplace and an institution's scope of business are continually evolving, making risk management a dynamic process. Nonetheless, an institution's risk-management system should

1. Existing policies and examiner guidance on various topics applicable to the evaluation of risk-management systems can also be found in supervisory letters SR-93-69, "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations," and SR-95-17, "Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities." Many of the managerial and examiner practices contained in these documents are fundamental and are generally accepted as sound practices for both trading and nontrading activities.

always be able to identify, aggregate, and control all risks posed by underwriting, trading, or dealing in securities that could have a significant impact on capital or equity.

Trading and market-risk limits should be customized to address the nature of the products and any unique risk characteristics. Common types of limits include earnings-at-risk limits, stop-loss limits, limits on notional amounts (both gross and duration-weighted), maturity limits, and maturity-gap limits. The level of sophistication needed within the limit matrix will depend on the type of instrument involved and the relative level of trading activity. Straightforward notional and tenor limits may be adequate for most dealers; however, dealers involved in a wide array of products and more complex transactions will need stronger tools to measure and aggregate risk across products.

In general, risk from trading and dealing activities can be broken down into the following categories:

- Market or price risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates and/or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution.
- Funding-liquidity risk refers to the ability to meet investment and funding requirements arising from cash-flow mismatches.
- Market-liquidity risk refers to the risk of being unable to close out open positions quickly enough and in sufficient quantities at a reasonable price.
- Credit risk is the risk that a counterparty to a transaction will fail to perform according to the terms and conditions of the contract, thus causing the security to suffer a loss in cashflow or market value. Because securities settlements are typically ''delivery vs. payment'' and settlement periods are relatively short, securities transactions do not involve a significant level of counterparty credit risk. Repurchase transactions, securities lending, and money market transactions, however, involve significantly higher levels of credit risk if not properly controlled. As a result, credit risk is discussed in greater detail in the subsections addressing these products. Credit risk can also arise from positions held in trading inventory. Although U.S. government and agency securities do not generally involve credit risk, other securities (for example, municipal and corporate securities) carried in inventory can decline in price due to a deterioration in credit quality.
- Clearing or settlement risk is (1) the risk that a counterparty who has received a payment or delivery of assets defaults before delivery of the asset or payment or (2) the risk that technical difficulties interrupt delivery or settlement despite the counterparty's ability or willingness to perform.
- Operations and systems risk is the risk of human error or fraud, or the risk that systems will fail to adequately record, monitor, and account for transactions or positions.
- Legal risk is the risk that a transaction cannot be consummated as a result of some legal barrier, such as inadequate documentation, a regulatory prohibition on a specific counterparty, non-enforceability of bilateral and multilateral close-out netting, or collateral arrangements in bankruptcy.

The *Trading Activities Manual* contains a comprehensive discussion of these risks, including examination objectives, procedures, and internal control questionnaires by risk category.

GOVERNMENT AND AGENCY SECURITIES

The government securities market is dominated by a number of investment banks, broker-dealers, and commercial banks known as primary dealers in government securities. These dealers make an over-the-counter market in most government and federal-agency securities. Primary dealers are authorized to deal directly with the Open Market Desk of the Federal Reserve Bank of New York. As market makers, primary dealers quote bid/ask prices on a wide range of instruments, and many publish daily quotation sheets or provide live electronic data feeds to larger customers or other dealers.

Government-security trading inventories are generally held with the objective of making short-term gains through market appreciation and dealer-initiated markups. Common factors that affect the markup differential include the size of a transaction, the dealer efforts extended, the type of customer (active or inactive), and the nature of the security. Markups on government securities generally range between one thirty-second and four thirty-seconds of a point. Long-maturity issues or derivative products may have higher markups due to the higher risk and potentially larger volatility that may be inherent in these products.

According to industry standards, payments for and deliveries of U.S. government and most agency securities are settled one business day following the trade date, although government dealers and customers can negotiate same-day or delayed settlement for special situations.

When-Issued Trading

A significant potential source of risk to dealers involves ''when-issued'' (WI) trading in government securities. WI trading is the buying and selling of securities in the one- to two-week interim between the announcement of an offering and the security auction and settlement. Although the vast majority of transactions settle on the next business day, WI trading results in a prolonged settlement period. This could increase both the market risk and counterparty credit risk associated with trading these instruments. The prolonged settlement period also provides an opportunity for a dealer to engage in a large volume of off-balance-sheet trading without having to fund the assets or cover the short positions. In essence, WI trading allows the dealers to create securities. If the overall level of WI trading is significant in relation to the size of the issue, the resulting squeeze on the market could increase volatility and risk. Given these potential risk characteristics, WI trading should be subject to separate sublimits to cap the potential exposure.

Short Sales

Another area of U.S. government–securities activity involves short-sale transactions. A short sale is the sale of a security that the seller does not own at the time of the sale. Delivery may be accomplished by buying the security or by borrowing the security. When the security delivered is borrowed, the short seller likely will ultimately have to acquire the security in order to satisfy its repayment obligation. The borrowing transaction is collateralized by a security (or securities) of similar value or cash (most likely the proceeds of the short sale). Reverse repurchase transactions are also used to obtain the security needed to make delivery on the security sold short. Carrying charges on borrowed government securities should be deducted from the short sale and purchase spread to determine net profit. Short sales are conducted to (1) accommodate customer orders, (2) obtain funds by leveraging existing assets, (3) hedge the market risk of other assets, or (4) allow a dealer to profit from a possible future decline in market price by purchasing an equivalent security at a later date at a lower price.

Government Securities Clearing

Securities-clearing services for the bulk of U.S. government–securities transactions and many federal-agency-securities transactions are provided by the Federal Reserve as part of its electronic securities-transfer system. The various Federal Reserve Banks will wire transfer most government securities between the book-entry safekeeping accounts of the seller and buyer. The Federal Reserve's systems also are used to facilitate security borrowings, loans, and pledges.

Government Securities Act

In response to the failures of a number of unregulated government securities dealers between 1975 and 1985, Congress passed the Government Securities Act of 1986 (GSA). GSA established, for the first time, a federal system for the regulation of the entire government securities market, including previously unregulated brokers and dealers. The primary goal of GSA was to protect investors and ensure the maintenance of a fair, honest, and liquid market.

The GSA granted the Department of the Treasury (Treasury) authority to develop and implement rules for transactions in government and agency securities effected by government securities brokers or dealers (that is, securities firms as well as other financial institutions), and to develop and implement regulations relating to the custody of government securities held by depository institutions. The rules were intended to prevent fraudulent and manipulative acts and practices and to protect the integrity, liquidity, and efficiency of the government securities market. At the same time, the rules were designed to preclude unfair discrimination among brokers, dealers, and customers. Enforcement of GSA regulation is generally carried out by an institution's primary regulatory organization.

The GSA regulations had the most significant effect on those entities that were not previously subject to any form of federal registration and regulation. These entities included not only firms registered as government securities brokers or dealers, but also firms registered as brokers or dealers trading in other securities and financial products. For the first time, the government securities activities of these entities were subject to the discipline of financial responsibility, customer protection, recordkeeping, and advertising requirements. For nonbank dealers, this regulation is enforced by a self-regulatory organization, the National Association of Securities Dealers, which conducts routine examinations under the oversight of the Securities Exchange Commission.

The provisions of GSA that had the most significant effect on government securities brokers and dealers (both bank and nonbank broker-dealers) relates to hold-in-custody repurchase agreement rules. Congress targeted this area because of abuses that had resulted in customer losses. Several requirements to strengthen customer protection were imposed: (1) written repurchase agreements must be in place, (2) the risks of the transactions must be disclosed to the customer, (3) specific repurchase securities must be allocated to and segregated for the customer, and (4) confirmations must be made and provided to the customer by the end of the day on which a transaction is initiated and on any day on which a substitution of securities occurs.

For a more detailed description of GSA requirements, refer to the procedures for the examination of government securities activities issued by the Board of Governors of the Federal Reserve System or to 17 CFR 400–450 for the actual text of the regulations.

Registration Exemptions

Most banks acting as government securities brokers or dealers are required to file a form known as a G-FIN. This form details the bank's capacity, the locations where government securities activities are performed, and the persons responsible for supervision. However, certain bank government securities activities are exempt from the filing requirements. Banks handling only U.S. savings bond transactions or submitting tender offers on original issue U.S. Treasury securities are exempt from registration.

Limited government-securities-brokerage activities are also exempt from registration under certain circumstances. Banks that engage in fewer than 500 government securities transactions annually (excluding savings bond transactions and Treasury tender offers) are exempt. Similarly, banks are exempt if they deal with a registered broker-dealer under a ''networking'' arrangement, assuming they meet the following conditions: (1) the transacting broker must be clearly identified, (2) bank employees perform only clerical or administrative duties and do not receive transaction-based compensation, and (3) the registered broker-dealer receives and maintains all required information on each customer. Exempt networking arrangements must be fully disclosed to the customer. Finally, banks are exempt from registration requirements if their activities are limited to purchases and sales in a fiduciary capacity and/or purchases and sales of repurchase or reverse repurchase agreements.

The preceding exemptions provide relief from registration, but exempt banks must comply (if applicable) with regulations addressing custodial holdings for customers (17 CFR 450). Additionally, banks effecting repurchase/reverse repurchase agreements must comply with repurchase-transaction requirements detailed in 17 CFR 403.5(d).

MUNICIPAL SECURITIES

Municipal securities are debt obligations issued by state and local governments and certain agencies and authorities. There are two broad categories of municipal bonds: general obligation bonds and revenue bonds. General obligation bonds (GOs) are backed by the full faith and credit and taxing authority of the government issuer. General obligation bonds are either limited- or unlimited-tax bonds. Limited-tax bonds are issued by government entities whose taxing authority is limited to some extent by law or statute. For instance, a local government may face restrictions on the level of property taxes it can levy on property owners. State and local entities may also issue special tax bonds, which are supported by a specific tax. For instance, a highway project may be financed by a special gasoline tax levied to pay for the bonds. Unlimited-tax bonds are issued by government entities that are not restricted by law or statute in the amount of taxes they can levy; however, there may be some political limitations.

Municipal revenue bonds are backed by a specific project or government authority, and they are serviced by fees and revenues paid by users of the government entity. Revenue bonds are backed by public power authorities, nonprofit hospitals, housing authorities, transportation authorities, and other public and quasipublic entities. Banks are generally prohibited from underwriting and dealing in municipal revenue bonds; however, an exemption has been established to allow banks to deal in revenue bonds that are backed by housing, university, or dormitory projects.

In addition to municipal bonds, state and local governments issue obligations to meet short-term funding needs. These obligations are normally issued in anticipation of some specific revenue. The types of debt issued include tax-anticipation notes (TANs), revenue-anticipation notes (TRANs), grants-anticipation notes (GANs), bond-anticipation notes (BANs), commercial paper, and others.

Because of the large number and diverse funding needs of state and local governments (over 50,000 state and local governments have issued debt in the United States), there are a wide variety of municipal securities. Some municipal security issues have complex structures that require an increased level of technical expertise to evaluate. As with all areas of banking, dealers who invest in complex instruments are expected to understand the characteristics of the instruments and how these instruments might affect their overall risk profile. While there are some large issuers, like the states of New York and California, most issuers are small government entities that place modest amounts of debt. Many of these issues are exempt from federal, state, and local income taxes, which, in part, determine the investor base for municipal bonds.

The customer base for municipal securities is investors that benefit from income that is exempt from federal income tax. This group includes institutional investors such as insurance companies, mutual funds, commercial banks, and retail investors, especially individuals in high-income-tax brackets.

Credit Risk

Municipal securities activities involve differing degrees of credit risk depending on the financial capacity of the issuer. Larger issuers of municipal securities are rated by nationally recognized rating agencies (Moody’s, S&P, etc.). Other municipalities achieve an investment grade rating through the use of credit enhancements, usually in the form of a standby letter of credit issued by a financial institution. Banks are also involved in underwriting and placing nonrated municipal securities. Nonrated issues are typically small and are placed with a limited number of investors. Liquidity in the secondary market is limited and bank dealers rarely carry nonrated issues in trading inventory.

Management should take steps to limit undue concentrations of credit risk arising from municipal security underwriting and dealing. Exposure to nonrated issuers should be approved through the bank’s credit-approval process with appropriate documentation to support the issuer’s financial capacity. Activity in nonrated issues outside the bank’s target or geographic market should also be avoided. In addition, exposure should be aggregated on a consolidated basis, taking into account additional credit risk arising from traditional banking products (loans, letters of credit, etc.).

Municipal Securities Rulemaking Board

The Securities Act Amendments of 1975 (15 USC 78o-4) extended a comprehensive network of federal regulation to the municipal securities markets. Pursuant to the act, municipal securities brokers and dealers are required to register with the Securities and Exchange Commission (SEC). The act also created a separate, self-regulatory body, the Municipal Securities Rulemaking Board (MSRB), to formulate working rules for the regulation of the municipal securities industry. The Federal Reserve is required to ensure compliance with those rules as they apply to state member banks.

A bank engaged in the business of buying and selling municipal securities must register with the SEC as a municipal securities dealer if it is involved in—

- underwriting or participating in a syndicate or

joint account for the purpose of purchasing securities;
- maintaining a trading account or carrying dealer inventory; or
- advertising or listing itself as a dealer in trade publications, or otherwise holding itself out to other dealers or investors as a dealer.

Generally, a bank that buys and sells municipal securities for its investment portfolio or in a fiduciary capacity is not considered a dealer.

If a bank meets the SEC's criteria for registering as a municipal securities dealer, it must maintain a separately identifiable department or division involved in municipal securities dealing under the supervision of officers designated by the bank's board of directors. These designated officers are responsible for municipal-securities-dealer activities and should maintain separate records.

The Federal Reserve conducts a separate examination of the municipal-securities-dealer activities in banks that engage in such activities. This examination is designed to ensure compliance with the rules and standards formulated by the MSRB. For a complete description of the activities of a municipal securities dealer and detailed procedures performed by the Federal Reserve examiners, refer to the *Municipal Securities Dealer Bank Examination Manual* issued by the Board of Governors of the Federal Reserve System.

REPURCHASE AGREEMENTS AND SECURITIES LENDING

Repurchase agreements (repos) play an important role in the securities markets. A repo is the simultaneous agreement to sell a security and repurchase it at a later date. Reverse repos are the opposite side of the transaction, securities purchased with a later agreement to resell. From the dealer's perspective, a repo is a financing transaction (liability) and a reverse repo is a lending transaction (asset). Overnight repos are a one-day transaction; anything else is referred to as a term repo. Approximately 80 percent of the repo market is overnight. Although any security can be used in a repurchase transaction, the overwhelming majority of transactions involve government securities.

Securities dealers use repos as an important source of liquidity. The majority of government-securities-trading inventory will typically be financed with repos. Reverse repos are used to obtain securities to meet delivery obligations arising from short positions or from the failure to receive the security from another dealer. Reverse repos also are an effective and low-risk means to invest excess cash on a short-term basis.

The repo rate is a money market rate that is lower than the federal-funds rate due to the collateralized nature of the transaction. Opportunities also arise to obtain below-market-rate financing. This situation arises when demand exceeds supply for a specific bond issue and it goes on "special." Dealers who own the bond or control it under a reverse repo transaction can earn a premium by lending the security. This premium comes in the form of a below-market-rate financing cost on a repo transaction.

Many of the larger dealers also engage in proprietary trading of a matched book, which consists of a moderate to large volume of offsetting repos and reverse repos. The term "matched book" is misleading as the book is rarely perfectly matched. Although profit may be derived from the capture of a bid/ask spread on matched transactions, profit is more often derived from maturity mismatches. In a falling-rate environment, traders lend long (reverse repos) and borrow short (repos). It is more difficult to profit in rising-rate environments because of the shape of the yield curve, which is usually upward-sloping. The overall size of the matched book and the length of the maturity mismatches will generally decline in a rising environment. Matched books are also used to create opportunities to control securities that may go on special, resulting in potential profit opportunities. Dealers engaging in matched-book trading provide important liquidity to the repo market.

Risk in a matched book should be minimized by establishing prudent limits on the overall size of the book, size of maturity mismatches, and restrictions on the maximum tenor of instruments. The overall risk of a matched book is usually small in relation to other trading portfolios. Maturity mismatches are generally short term, usually 30 to 60 days, but may extend up to one year. Risk can be quickly neutralized by extending the maturity of assets or liabilities. Off-balance-sheet instruments (futures and forward-rate agreements) can also be used to reduce risk.

Securities dealers may also engage in "dollar-roll'' transactions involving mortgage-backed securities, which are treated as secured financings for accounting purposes. The ''seller'' of the security agrees to repurchase a ''substantially identical'' security from the ''buyer,'' rather than the same security. Many of the supervisory considerations noted above for repurchase agreements also apply to dollar-roll transactions. However, if the security to be repurchased is not substantially identical to the security sold, the transaction generally should be accounted for as a sale and not as a financing arrangement. The accounting guidance for substantially identical is described in AICPA Statement of Position 90-3, which generally requires debt instruments to have the same primary obligor or guarantor, the same form and type, the identical contractual interest rate, the same maturity or weighted average maturity, and other factors.

In addition, securities dealers may engage in securities-lending or -borrowing transactions. In substance, these transactions are very similar to repo transactions except the transactions have no stated maturity. The transactions are conducted through open-ended ''loan'' agreements that may be terminated on short notice by the lender or borrower. Although lending transactions have historically been centered in corporate debt and equity obligations, the market increasingly involves loans of large blocks of U.S. government and federal-agency securities. To participate in this market, a bank may lend securities held in its investment account or trading account. Like repos, securities are lent to cover fails (securities sold but not available for delivery) and short sales. Collateral for the transactions can consist of other marketable securities or standby letters of credit; however, the large majority of transactions are secured by cash. Investors are willing to lend securities due to the additional investment income that can be earned by investing the cash collateral. When a securities loan is terminated, the securities are returned to the lender and the collateral to the borrower.

Credit Risk

Since repurchase agreements and securities-lending transactions are collateralized, credit risk is relatively minor if properly controlled. Some dealers have underestimated the credit risk associated with the performance of the counterparty and have not taken adequate steps to ensure their control of the securities serving as collateral. The market volatility of the securities held as collateral can also add to the potential credit risk associated with the transaction.

As an added measure of protection, dealers require customers to provide excess collateral. This excess is referred to as ''margin.'' The size of the margin will be a function of the volatility of the instrument serving as collateral and the length of the transaction. In addition to initial margin, term repos and security-lending arrangements require additional margin if the value of the collateral declines below a specified level. Excess margin is usually returned to the counterparty if the value of the collateral increases. A daily ''mark-to-market'' or valuation procedure must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should be independent of the trader and take into account the value of accrued interest on debt securities. It is important to point out that credit risk can arise from both asset transactions (reverse repos and securities borrowed) and liability transactions (repos and securities lent) because of market fluctuations in collateral provided and received. Dealers should take steps to ensure that collateral provided is not excessive.

Policies and procedures should be in place to ensure transactions are conducted only with approved counterparties. Credit-limit approvals should be based on a credit analysis of the borrower. An initial review should be performed before establishing a relationship, with periodic reviews thereafter. Credit reviews should include an analysis of the borrower's financial statement, capital, management, earnings, business reputation, and any other relevant factors. Analyses should be performed in an independent department of the lender institution, by persons who routinely perform credit analyses. Analyses performed solely by the person managing the repo or securities-lending programs are not sufficient. Credit and concentration limits should take into account other extensions of credit by other departments of the bank or affiliates. Procedures should be established to ensure that credit and concentration limits are not exceeded without proper authorization from management.

Other Uses and Implications of Securities Lending

In addition to lending their own securities, financial institutions have become increasingly involved in lending customers' securities held in custody, safekeeping, trust, or pension accounts. These activities are typically organized within the bank's trust department. Not all institutions that lend securities or plan to do so have relevant experience. Because the securities available for lending often greatly exceed the demand, inexperienced lenders may be tempted to ignore commonly recognized safeguards. Bankruptcies of broker-dealers have heightened regulatory sensitivity to the potential for problems in this area.

Fees received on securities loans are divided between the custodial institution and the customer account that owns the securities. In situations involving cash collateral, part of the interest earned on the temporary investment of cash is returned to the borrower and the remainder is divided between the lender institution and the customer account that owns the securities.

In addition to a review of controls, examiners should take steps to ensure that cash collateral is invested in appropriate instruments. Cash should be invested in high-quality, short-term money market instruments. Longer term floating-rate instruments may also be appropriate; however, illiquid investments and products with customized features (for example, structured notes with imbedded options) should be avoided. Several banks have reported significant losses associated with inappropriate investments in securities lending areas.

Definitions of Capacity

Securities lending may be done in various capacities and with differing associated liabilities. It is important that all parties involved understand in what capacity the lender institution is acting. The relevant capacities are described below.

Principal

A lender institution offering securities from its own account is acting as principal. A lender institution offering customers' securities on an undisclosed basis is also considered to be acting as principal.

Agent

A lender institution offering securities on behalf of a customer-owner is acting as an agent. In order to be considered a bona fide or ''fully disclosed'' agent, the lending institution must disclose the names of the borrowers to the customer-owners and the names of the customer-owners to the borrowers (or give notice that names are available upon request). In all cases, the agent's compensation for handling the transaction should be disclosed to the customer-owner. Undisclosed agency transactions, that is, ''blind brokerage'' transactions in which participants cannot determine the identity of the contraparty, are treated as if the lender institution were the principal. (See definition above.)

Directed Agent

A lender institution that lends securities at the direction of the customer-owner is acting as a directed agent. The customer directs the lender institution in all aspects of the transaction, including to whom the securities are loaned, the terms of the transaction (rebate rate and maturity/call provisions on the loan), acceptable collateral, investment of any cash collateral, and collateral delivery.

Fiduciary

A lender institution that exercises discretion in offering securities on behalf of and for the benefit of customer-owners is acting as a fiduciary. For supervisory purposes, the underlying relationship may be as agent, trustee, or custodian.

Finder

A finder brings together a borrower and a lender of securities for a fee. Finders do not take possession of the securities or collateral. Delivery of securities and collateral is directly between the borrower and the lender, and the finder does not become involved. The finder is simply a fully disclosed intermediary.

MONEY MARKET INSTRUMENTS

In addition to bank-eligible securities activities, banks may engage in a substantial volume of trading in money market instruments. Federal funds, banker's acceptances, commercial paper, and certificates of deposit are forms of money market instruments. While these instruments may be used as part of the overall funding strategy, many firms actively engage in discretionary or proprietary trading in these instruments. As in matched-book repo activities, profits from trading money market instruments are derived from the bid/ask spread on matched transactions and the net-interest spread from maturity mismatches.

This activity may result in overall money market arbitrage. Arbitrage is the coordinated purchase and sale of the same security or its equivalent, for which there is a relative price imbalance in the market. The objective of such activity is to obtain earnings by taking advantage of changing yield spreads. Arbitrage can occur with on-balance-sheet items such as Eurodollar CDs, bankers' acceptances, and federal funds, and with off-balance-sheet items such as futures and forwards.

Although the risk of money market trading is relatively straightforward, the potential risk can be significant based on the volume of trading and size of the mismatches. Despite the potential risk, these activities may offer attractive profit opportunities if effectively controlled. Short-term interest-rate markets are very liquid, and risk can be quickly neutralized by changing the maturity profile of either assets or liabilities. Off-balance-sheet instruments (futures and forward-rate agreements) can also be an effective tool to manage risk. Money market trading may be managed as a separate product line or may be integrated with trading in other interest-rate products (swaps, caps, floors, etc.). Examiners should take steps to ensure that appropriate limits are in place for money market trading, including restrictions on aggregate notional size, the size of maturity mismatches, and the maximum tenor of instruments.

Federal Funds

Commercial banks actively use the federal-funds market as a mechanism to manage fluctuations in the size and composition of their balance sheet. Federal funds are also an efficient means to manage reserve positions and invest excess cash on a short-term basis. Although transactions are generally unsecured, they can also be secured. The majority of transactions are conducted overnight; however, term transactions are also common. Federal-funds trading will often involve term transactions in an attempt to generate positive net-interest spread by varying the maturities of assets and liabilities.

Banks have traditionally engaged in federal-funds transactions as principal, but an increasing number of banks are conducting business as agent. These agency-based federal-funds transactions are not reported on the agents' balance sheet. Dealer banks may also provide federal-funds-clearing services to their correspondent banks.

Banker's Acceptances

Banker's acceptances are time drafts drawn on and accepted by a bank. They are the customary means of effecting payment for merchandise sold in import-export transactions, as well as a source of financing used extensively in international trade. Banker's acceptances are an obligation of the acceptor bank and an indirect obligation of the drawer. They are normally secured by rights to the goods being financed and are available in a wide variety of principal amounts. Maturities are generally less than nine months. Acceptances are priced like Treasury bills, with a discount figured for the actual number of days to maturity based on a 360-day year. The bank can market acceptances to the general public but must guarantee their performance.

Commercial Paper

Commercial paper is a generic term that is used to describe short-term, unsecured promissory notes issued by well-recognized and generally sound corporations. The largest issuers of commercial paper are corporations, bank holding companies, and finance companies, which use the borrowings as a low-cost alternative to bank financing. Commercial paper is exempt from registration under the Securities Act of 1933 if it meets the following conditions:

- prime quality and negotiable
- not ordinarily purchased by the general public
- issued to facilitate current operational business requirements
- eligible for discounting by a Federal Reserve Bank
- maturity does not exceed nine months

Actively traded commercial paper is ordinarily issued in denominations of at least $100,000 and often in excess of $1 million. Commercial-paper issuers usually maintain unused bank credit lines to serve as a source of back-up liquidity or contingency financing, principally in the form of standby letters of credit. Major commercial-paper issuers are rated by nationally recognized rating agencies (Moody's, S&P, etc.). Other issuers achieve higher ratings through the use of a credit enhancement, usually in the form of a standby letter of credit issued by a financial institution.

Based on Supreme Court rulings, commercial paper is considered a security for Glass-Steagall purposes. As a result, banks are generally prohibited from underwriting and dealing in commercial paper. Despite this restriction, banks have participated in this market in an "agency capacity." When establishing a commercial-paper dealership, many of the larger banks have pursued business through an aggressive interpretation of an agency-transaction role. In practice, bank dealers engage in riskless principal or best-efforts placement of commercial paper. Taking this logic a step further, others actively engage in competitive bidding and intraday distribution of newly issued paper. Because the paper settles on a same-day basis, the transactions are never part of the official end-of-day records of the bank. Although this technical point has been the subject of discussion, the practice has not been subject to regulatory challenge. Most of the larger banks have moved commercial-paper activities into section 20 subsidiaries to allow more flexibility in serving this market segment.

Commercial paper may be issued as an interest-bearing instrument or at a discount. Market trades are priced at a current yield, net of accrued interest due the seller or, if the commercial paper was issued at a discount, at a discount figured for the actual number of days to maturity based on a 360-day year.

The sale of commercial paper issued by bank affiliates must be conducted in a manner that conforms to legal restrictions and avoids conflicts of interest. Each certificate and confirmation should disclose the facts that the commercial paper is not a deposit and is not insured by the Federal Deposit Insurance Corporation.

Certificates of Deposit

Negotiable CDs issued by money-center banks are actively traded in denominations of $100,000 to $1 million. Interest generally is calculated on a 360-day year and paid at maturity. Secondary market prices are computed based on current yield, net of accrued interest due the seller. Eurodollar CDs trade like domestic CDs except their yields are usually higher and their maturities are often longer.

Credit-Risk and Funding Concentrations

In addition to market risk, money market policies and guidelines should recognize the credit risk inherent in these products. Federal funds sold and deposit placements are essentially unsecured advances. To avoid undue concentrations of credit risk, activity with these products should be limited to approved counterparties. Limits should be established for each prospective counterparty. Tenor limits should also be considered to reduce the potential for credit deterioration over the life of the transaction. The size of limits should be based on both anticipated activity and the counterparty's financial capacity to perform. The credit analysis should be performed by qualified individuals in a credit department that is independent from the money market dealing function. In assessing the creditworthiness of other organizations, institutions should not rely solely on outside sources, such as standardized ratings provided by independent rating agencies, but should perform their own analysis of a counterparty's or issuer's financial strength. At a minimum, limits should be reassessed and credit analyses updated annually. Once established, limits should be monitored with exceptions documented and approved by the appropriate level of senior management. Exposure should also be aggregated on a consolidated basis with any other credit exposure arising from other product areas. Exposure to foreign-bank counterparties should also be aggregated by country of domicile to avoid country-risk concentrations. The limit structure should be reviewed to ensure compliance with the requirements of Regulation F (Interbank Liabilities), which places prudent limits on credit exposure to correspondent banks.

Maintaining a presence in the wholesale funding markets requires a strong reputation and increases potential liquidity risk. The prolonged use of a large volume of purchased funds to support a money market trading operation could also reduce the capacity to tap this market if needed for core funding. Guidelines should be in place to diversify sources of funding. Contingency plans should include strategies to exit or reduce the profile in these markets if the situation warrants.

OPERATIONS AND INTERNAL CONTROLS

A bank dealer's operational functions should be designed to regulate the custody and movement of securities and to adequately account for trading transactions. Because of the dollar volume and speed of trading activities, operational inefficiencies can quickly result in major problems.

Sound Practices for Front- and Back-Office Operations

Bank dealer activities vary significantly among financial institutions, depending on the size and complexity of the trading products; trading, back-office, and management expertise; and the sophistication of systems. As a result, practices, policies, and procedures in place in one institution may not be necessary in another. The adequacy of internal controls requires sound judgment on the part of the examiner. The following is a list of policies and procedures that should be reviewed:

- Every organization should have comprehensive policies and procedures in place that describe the full range of bank dealer activities performed. These documents, typically organized into manuals, should at a minimum address front- and back-office operations; reconciliation guidelines and frequency; revaluation and accounting guidelines; descriptions of accounts; broker policies; a code of ethics; and the risk-measurement and management methods, including a comprehensive limit structure.
- Every institution should have existing policies and procedures to ensure the segregation of duties among the trading, control, and payment functions.
- Revaluation sources should be independent from the traders for accounting purposes, risk oversight, and senior management reporting, although revaluation of positions may be conducted by traders to monitor positions.
- Trader and dealer telephone conversations should be taped to facilitate the resolution of disputes and to serve as a valuable source of information to auditors, managers, and examiners.
- Trade tickets and blotters (or their electronic equivalents) should be timely and complete to allow for easy reconciliation and for appropriate position and exposure monitoring. The volume and pace of trading may warrant virtually simultaneous creation of these records in some cases.
- Computer hardware and software applications must have the capacity to accommodate the current and projected level of trading activity. Appropriate disaster-recovery plans should be tested regularly.
- Every institution should have a methodology to identify and justify any off-market transactions. Ideally, off-market transactions would be forbidden.
- A clear institutional policy should exist for personal trading. If such trading is permitted at all, procedures should be established to avoid even the appearance of conflicts of interest.
- Every institution should ensure that the management of after-hours and off-premises trading, if permitted at all, is well documented so that transactions are not omitted from the automated blotter or the bank's records.
- Every institution should ensure that staff is both aware of and complies with internal policies governing the trader-broker relationship.
- Every institution that uses brokers should monitor the patterns of broker usage, be alert to possible undue concentrations of business, and review the list of approved brokers at least annually.
- Every institution that uses brokers should establish a policy that minimizes name sub-

stitutions of brokered transactions. All such transactions should be clearly designated as switches and relevant credit authorities should be involved.

- Every institution that uses brokers for foreign-exchange transactions should establish a clear statement forbidding the lending or borrowing of brokers' points as a method to resolve discrepancies.
- Every organization should have explicit compensation policies to resolve disputed trades for all traded products. Under no circumstances should "soft-dollar" (the exchange of services in lieu of dollar compensation) or off-the-books compensation be permitted for dispute resolution.
- Every institution should have "know-your-customer" policies, and they should be understood and acknowledged by trading and sales staff.
- The designated compliance officer should perform a review of trading practices at least annually. In institutions with a high level of trading activity, interim reviews may be warranted.
- The organization should have an efficient confirmation-matching process that is fully independent from the dealing function. Documentation should be completed and exchanged as close to completion of a transaction as possible.
- Auditors should review trade integrity and monitoring on a schedule in accordance with its appropriate operational risk designation.
- Organizations that have customers who trade on margin should establish procedures for collateral valuation and segregated custody accounts.

Fails

In some cases, a bank may not receive or deliver a security by settlement date. "Fails" to deliver for an extended time, or a substantial number of cancellations, are sometimes characteristic of poor operational control or questionable trading activities.

Fails should be controlled by prompt reporting and follow-up procedures. The use of multicopy confirmation forms enables operational personnel to retain and file a copy by settlement date and should allow for prompt fail reporting and resolution.

Revaluation

The frequency of independent revaluation should be driven by the level of an institution's trading activity. Trading operations with high levels of activity may need to perform daily revaluation; however, it is important to note that independent revaluations are less critical in situations where inventory is turning over quickly or end-of-day positions are small. In these situations, the majority of profit and loss is realized rather than unrealized. Only unrealized profit and loss on positions carried in inventory are affected by a revaluation. At a minimum, every institution should conduct an independent revaluation at the end of each standard accounting period (monthly or quarterly). There will be situations when certain securities will be difficult to price due to lack of liquidity or recent trading activity. If management relies on trader estimates in these situations, a reasonableness test should be performed by personnel who are independent from the trading function. A matrix-pricing approach may also be employed. This involves the use of prices on similar securities (coupon, credit quality, and tenor) to establish market prices.

Control of Securities

Depository institutions need to adopt procedures to ensure that ownership of securities is adequately documented and controlled. While this documentation and control once involved taking physical possession of the securities either directly or through a third-party custodian, the securities markets are quickly moving to a book-entry system. In this context, safekeeping is more of a concept than a reality. As the markets change, documenting the chain of ownership becomes the primary mechanism to prevent losses arising from a counterparty default. This documentation involves the matching of incoming and outgoing confirmations and frequent reconcilements of all accounts holding securities (Federal Reserve, customer, custodian, and other dealers). In situations where the dealer holds securities on behalf of its customers, similar safeguards also need to be in place. Although this documentation process can be burdensome, it is necessary to protect a dealer's interest in securities owned or controlled. Many active dealers have automated the reconcilement and matching process. This reduces the potential for human error and increases the likelihood that exceptions can be uncovered and resolved quickly.

Because of the relatively short periods of actual ownership associated with repurchase agreements, potential losses could be significant if prudent safeguards are not followed. Significant repo volume or matched-book trading activities only heighten this concern. To further protect their interests, dealers should enter into written agreements with each prospective repurchase-agreement counterparty. Although the industry is moving toward standardized master agreements, some degree of customization may occur. The agreements should be reviewed by legal counsel for content and compliance with established minimum documentation standards. In general, these agreements should specify the terms of the transaction and the duties of both the buyer and seller. At a minimum, provisions should cover the following issues:

- acceptable types and maturities of collateral securities
- initial acceptable margin for collateral securities of various types and maturities
- margin maintenance, call, default, and sellout provisions
- rights to interest and principal payments
- rights to substitute collateral
- individuals authorized to transact business on behalf of the depository institution and its counterparty

Written agreements should be in place before commencing activities.

TRADING ACTIVITIES MANUAL

The *Trading Activities Manual*, developed by the Federal Reserve System, is a valuable tool to help examiners understand the complex and often interrelated risks arising from capital-markets activities. The products addressed in the previous subsections and their associated risks are covered in greater detail in the manual.

As noted in the preceding sections, and further addressed in the *Trading Activities Manual*, other trading instruments could be included in the bank dealer or money market trading operation. Off-balance-sheet instruments such as futures and forward-rate agreements are often used to modify or hedge the risk associated with cash instruments (dealer inventory and money market positions). The bank dealer may also be involved in other instruments including asset-backed securities (mortgage-backed and consumer receivable–backed). Other departments of the bank may also use securities products as part of an unrelated trading activity. For example, interest-rate swap traders often use cash bonds to hedge or modify market-risk exposure. In this capacity, the swap desk would be a customer of the government securities dealer. These overlaps in product focus and usage make it critical for examiners to understand the organizational structure and business strategies before establishing examination scope.

OTHER ISSUES

Intercompany Transactions

Examiners should review securities and repurchase-agreement transactions with affiliates to determine compliance with sections 23A and 23B of the Federal Reserve Act. Money market transactions may also be subject to limitations under section 23A; however, these restrictions generally do not apply to transactions between bank subsidiaries that are 80 percent or more commonly owned by a bank holding company. Intercompany transactions between section 20 subsidiaries and their affiliates should be carefully reviewed to ensure compliance with firewall provisions.

Agency Relationships

Many dealer banks engage in securities transactions only in an agency capacity. Acting as an agent means meeting customers' investment needs without exposing the firm to the price risk associated with dealing as principal. Risk is relatively low as long as appropriate disclosures are made and the bank does not misrepresent the nature or risk of the security.

Agency-based federal-funds transactions are also becoming more common. By serving only as an agent to facilitate the transaction, a bank can meet its correspondent's federal-funds needs without inflating the balance sheet and using capital. Examiners should review agency-based money market transactions to ensure that the transactions are structured in a manner that insulates the bank from potential recourse, either moral or contractual. If legal agreements are not structured properly, the courts could conclude that the agent bank was acting a principal. In this situation, the loss could be recognized by the agent bank, not its customer.

Although no single feature can determine whether an agency relationship really exists, the courts have recognized a variety of factors in distinguishing whether the persons to whom "goods" were transferred were buyers or merely agents of the transferor. Although some of these distinguishing factors may not apply to federal-funds transactions because they involve the transfer of funds rather than material goods, some parallels can be drawn. An agency relationship would appear to encompass, although not necessarily be limited to, the following elements:

- The agent bank must agree to act on behalf of the seller of the federal funds ("seller") and not on its own behalf.
- The agent should fully disclose to all parties to the transaction that it is acting as agent on behalf of the seller and not on its own behalf.
- The seller, not the agent bank, must retain title to the federal funds before their sale to a purchasing institution.
- The seller, not the agent bank, must bear the risk of loss associated with the federal-funds sale.
- The agent bank's authority in selling federal funds and accounting for these sales to the seller should be controlled by the seller or by some guidelines to which the seller has agreed. The agent bank should sell only to those banks stipulated on a list of banks approved, reviewed, and confirmed periodically by the seller bank.
- The agent bank should be able to identify the specific parties (sellers and purchasers) to a federal-funds sale and the amount of each transaction for which the agent has acted.
- The agent bank's compensation should generally be based on a predetermined fee schedule or percentage rate (for example, a percentage based on the number or size of transactions). The agent should generally not receive compensation in the form of a spread over a predetermined rate that it pays to the seller. (If the agent bank's compensation is in the form of a spread over the rate it pays to the seller, this situation would appear to be more analogous to acting as a principal and suggests that the transactions should be reported on the "agent's" balance sheet.)

By structuring agency agreements to include provisions that encompass these factors and by conducting agency activities accordingly, agent banks can lower the possibility that they would be considered a principal in the event of a failure of a financial institution that had purchased funds through the agent. Generally, as a matter of prudent practice, each bank acting as an agent should have written agreements with principals encompassing the above elements and have a written opinion from legal counsel as to the bona fide nature of the agency relationships.

Selling through an agent should not cause a bank to neglect a credit evaluation of the ultimate purchasers of these funds. Under the more traditional mode of conducting federal-funds transactions, banks sell their federal funds to other banks, which in many instances are larger regional correspondents. These correspondent banks in turn may resell the federal funds to other institutions. Since the correspondent is acting as a principal in these sales, the banks selling the funds to the correspondent are generally not concerned about the creditworthiness of those purchasing the federal funds from the correspondent/principal. Rather, the original selling banks need to focus solely on the creditworthiness of their correspondent banks, with which they should be quite familiar.

However, when conducting federal-funds sales through an agent, selling banks, in addition to considering the financial condition of their agent, should also subject the ultimate purchasing banks to the same type of credit analysis that would be considered reasonable and prudent if the seller banks were lending directly to the ultimate borrowers rather than through agents. Banks selling federal funds through agents should not relinquish their credit-evaluation responsibilities to their agent banks.

REPORTING

Securities held for trading purposes and the income and expense that results from trading activities should be isolated by specific general ledger or journal accounts. The balances in those accounts should be included in the appropriate reporting categories for regulatory reporting.

Instructions for the Consolidated Report of Condition and Income (call report) require that securities, derivative contracts, and other items held in trading accounts be reported consistently at market value, or at the lower of cost or market value, with unrealized gains and losses recognized in current income. For further detail, refer to the glossary section of the call report instructions under ‘‘trading account.’’ With either method, the carrying values of trading-security inventories should be evaluated periodically (monthly or quarterly), based on current market prices. The increase or decrease in unrealized appreciation or depreciation resulting from that revaluation should be credited or charged to income. Periodic independent revaluation is the most effective means of measuring the trading decisions of bank management.

For reporting purposes, the trading department's income should include not only revaluation adjustments, but also profits and losses from the sale of securities, and other items related to the purchase and sale of trading securities. Interest income from trading assets, salaries, commissions, and other expenses should be excluded from trading income for reporting purposes; however, these items should be considered by management when evaluating the overall profitability of the business.

When the lender institution is acting as a fully disclosed agent, securities-lending activities need not be reported on the call report. However, lending institutions offering indemnification against loss to their customer-owners should report the associated contingent liability gross in Schedule RC-L as ‘‘other significant commitments and contingencies.’’

Recordkeeping and Confirmation Rules

Regulation H contains rules establishing uniform standards for bank recordkeeping, confirmation, and other procedures in executing securities transactions for bank customers. The regulation applies, in general, to those retail commercial activities where the bank effects securities transactions at the direction and for the account of customers. The purpose of the rules is to ensure that purchasers of securities are provided adequate information concerning a transaction and that adequate records and controls are maintained for securities transactions. Under the rules, banks are required to maintain certain detailed records concerning securities transactions, to provide written confirmations to customers under certain circumstances, and to establish certain written policies and procedures. The requirements generally do not apply to banks that make 200 or fewer securities transactions a year for customers (exclusive of transactions in U.S. government and agency obligations) and to transactions subject to the requirements of the MSRB.

Due Bills

A ‘‘due bill’’ is an obligation that results when a firm sells a security or money market instrument and receives payment, but does not deliver the item sold. Due bills issued should be considered as borrowings by the issuing firm, and alternatively, due bills received should be considered as lending transactions. Dealers should not issue due bills as a means of obtaining operating funds or when the underlying security can be delivered at settlement. Customers of the dealer enter transactions with an implicit understanding that securities transactions will be promptly executed and settled unless there is a clear understanding to the contrary. Consequently, dealers should promptly disclose the issuance of a due bill to a customer when funds are taken but securities or money market instruments are not delivered to the customer. Such disclosure should reference the applicable transaction; state the reason for the creation of a due bill; describe any collateral securing the due bill; and indicate that to the extent the market value of the collateral is insufficient, the customer may be an unsecured creditor of the dealer.

Due bills that are outstanding for more than three days and are unsecured could be construed as funding and should be reported as ‘‘liabilities for borrowed monies’’ on the call report. These balances are subject to reserve requirements imposed by Regulation D.

ESTABLISHING SCOPE

Obtaining an overview of the organization, management structure, products offered, and control environment is a critical step in the examination process. Based on this assessment, an examiner should determine the appropriate resources and skill level. In situations where an institution is active in either the government or municipal securities markets, it is essential to allocate additional resources for GSA and MSRB compliance. The assigned examiners should be familiar with the provisions of GSA and MSRB as well as with the related examination procedures. For active proprietary trading units, it is important to assign examiners who have a reasonable working knowledge of the concepts outlined in the *Trading Activities Manual*.

1. To determine if the policies, practices, procedures, and internal controls regarding bank dealer activities are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the trading portfolio for credit quality and marketability.
4. To determine the scope and adequacy of the audit compliance functions.
5. To determine compliance with applicable laws and regulations.
6. To ensure investor protection.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

1. If selected for implementation, complete or update the Bank Dealer Activities section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ‘‘Internal Control,’’ and determine if corrections have been accomplished.
4. Request that the bank provide the following schedules:
   a. An aged schedule of securities that have been acquired as a result of underwriting activities.
   b. An aged schedule of trading account securities and money market instruments held for trading or arbitrage purposes. Reflect commitments to purchase and sell securities and all joint account interests.
   c. A schedule of short-sale transactions.
   d. An aged schedule of due bills.
   e. A list of bonds borrowed.
   f. An aged schedule of ‘‘fails’’ to receive or deliver securities on unsettled contracts.
   g. A schedule of approved securities borrowers and approved limits.
   h. A schedule of loaned securities.
   i. A schedule detailing account names and/or account numbers of the following customer accounts:
      • Own bank trust accounts.
      • Own bank permanent portfolio.
      • Affiliated banks’ permanent portfolio accounts.
      • Personal accounts of employees of other banks.
      • Accounts of brokers or other dealers.
      • Personal accounts of employees of other brokers or dealers.
   j. A list of all joint accounts entered into since the last examination.
   k. A list of underwriting since the last examination and whether such securities were acquired by negotiation or competitive bid.
   l. A list of all financial advisory relationships.
5. Agree balances of appropriate schedules to general ledger and review reconciling items for reasonableness.
6. Determine the extent and effectiveness of trading policy supervision by:
   a. Reviewing the abstracted minutes of meetings of the board of directors and/or of any appropriate committee.
   b. Determining that proper authorization for the trading officer or committee has been made.
   c. Ascertaining the limitations or restrictions on delegated authorities.
   d. Evaluating the sufficiency of analytical data used in the most recent board or committee trading department review.
   e. Reviewing the methods of reporting by department supervisors and internal auditors to ensure compliance with established policy and law.
   f. Reaching a conclusion about the effectiveness of director supervision of the bank’s trading policy. Prepare a memo for the examiner assigned ‘‘Duties and Responsibilities of Directors’’ stating your conclusions. All conclusions should be supported by factual documentation.

(Before continuing, refer to steps 14 and 15. They should be performed in conjunction with the remaining examination steps.)

7. Ascertain the general character of underwriting and direct placement activities and the effectiveness of department management by reviewing underwriter files and ledgers, committee reports and offering statements to determine:
   a. The significance of underwriting activities and direct placements of type III securities as reflected by the volume of sales and profit or loss on operations. Compare current data to comparable prior periods.
   b. Whether there is a recognizable pattern in:
      • The extent of analysis of material

information relating to the ability of the issuer to service the obligation.
- Rated quality of offerings.
- Point spread of profit margin for unrated issues.
- Geographic distribution of issuers.
- Syndicate participants.
- Bank's trust department serving as corporate trustee, paying agent and transfer agent for issuers.
- Trustee, paying agent and transfer agent business being placed with institutions that purchase a significant percentage of the underwriter or private placement offering.

c. The volume of outstanding bids. Compare current data to comparable prior periods.

d. The maturity, rated quality and geographic distribution of takedowns from syndicate participations.

e. The extent of transfer to the bank's own or affiliated investment or trading portfolios or to trust accounts and any policies relating to this practice.

8. Determine the general character of trading account activities and whether the activities are in conformance with stated policy by reviewing departmental reports, budgets and position records for various categories of trading activity and determining:

a. The significance of present sales volume compared to comparable prior periods and departmental budgets.

b. Whether the bank's objectives are compatible with the volume of trading activity.

9. Review customer ledgers, securities position ledgers, transaction or purchase and sales journals and analyze the soundness of the bank's trading practices by:

a. Reviewing a representative sample of agency and contemporaneous principal trades and determining the commission and price mark-up parameters for various sizes and types of transactions.

b. Selecting principal transactions that have resulted in large profits and determining if the transaction involved:
- ''Buy-backs'' of previously traded securities.
- Own bank or affiliated bank portfolios.
- A security that has unusual quality and maturity characteristics.

c. Reviewing significant inventory positions taken since the prior examination and determining if:
- The quality and maturity of the inventory position was compatible with prudent banking practices.
- The size of the position was within prescribed limits and compatible with a sound trading strategy.

d. Determining the bank's exposure on offsetting repurchase transactions by:
- Reviewing the maturities of offsetting re-po and reverse re-po agreements to ascertain the existence, duration, amounts and strategy used to manage unmatched maturity ''gaps'' and extended (over 30 days) maturities.
- Reviewing records since the last examination to determine the aggregate amounts of:
  — Matched repurchase transactions.
  — Reverse re-po financing extended to one or related firms(s).
- Performing credit analysis of significant concentrations with any single or related entity(ies).
- Reporting the relationship of those concentrations to the examiners assigned ''Concentration of Credits'' and ''Funds Management.''

10. Determine the extent of risk inherent in trading account securities which have been in inventory in excess of 30 days and:

a. Determine the dollar volume in extended holdings.

b. Determine the amounts of identifiable positions with regard to issue, issuer, yield, credit rating, and maturity.

c. Determine the current market value for individual issues which show an internal valuation mark-down of 10 percent or more.

d. Perform credit analyses on the issuers of non-rated holdings identified as significant positions.

e. Perform credit analyses on those issues with valuation write-downs considered significant relative to the scope of trading operations.

f. Discuss plans for disposal of slow moving inventories with management and determine the reasonableness of those plans in light of current and projected market trends.

11. Using an appropriate technique, select issues

from the schedule of trading account inventory. Test valuation procedures by:

a. Reviewing operating procedures and supporting workpapers and determining if prescribed valuation procedures are being followed.
b. Comparing bank prepared market prices, as of the most recent valuation date, to an independent pricing source (use trade date "bid" prices).
c. Investigating any price differences noted.

12. Using an appropriate technique, select transactions from the schedule of short sales and determine:
    a. The degree of speculation reflected by basis point spreads.
    b. Present exposure shown by computing the cost to cover short sales.
    c. If transactions are reversed in a reasonable period of time.
    d. If the bank makes significant use of due-bill transactions to obtain funds for its banking business:
       • Coordinate with the examiner assigned "Review of Regulatory Reports" to determine if the bank's reports of condition reflect due bill transactions as "liabilities for borrowed money."
       • Report amounts, duration, seasonal patterns and budgeted projections for due bills to the examiner assigned "Funds Management."
13. If the bank is involved in agency-based federal funds activity:
    a. At the beginning or in advance of each examination of a banking organization which has been acting as an agent in the purchase and sale of federal funds for other institutions, examiners should obtain certain information which will help them determine the nature and extent of this activity. The information should include:
       • A brief description of the various types of agency relationships (i.e., involving federal funds or other money market activities) and the related transactions.
       • For each type of agency relationship, copies of associated forms, agency agreements, documents, reports and legal opinions. In addition, if the banking organization has documented its analysis of the risks associated with the activity, a copy of the analysis should be requested by the examiner.
       • For each type of agency relationship, a summary of the extent of the activity including:
         — The number of institutions serviced as principals.
         — The size range of the institutions (i.e., institutions serviced have total assets ranging from $______ to $______).
         — General location of sellers and purchasers serviced under agency relationships (i.e., New York State, Midwest, etc.)
         — Estimate of average daily volume of federal funds or money market instruments purchased and sold under agency relationships and the high and low volume over the period since the last examination inquiry (or since activity was begun, if more recent).
         — Names of individuals in the bank that are responsible for these agency relationships.
       • A historical file of this information should be maintained in order to determine the nature, extent and growth of these activities over time.
    b. Once the examination work in this area has been started, the examiner should attempt to discern any situation, activity or deficiency in this area that might suggest that an agency relationship does *not* actually exist. A negative response to the following examination guidelines section dealing with agency agreements may signal such a deficiency. In addition, any other money market agency relationships that involve new or unusual financial transactions should be evaluated to determine the nature of the risks involved and compliance, to the extent applicable, with the guidelines.
    c. The examiner should determine that the banking organization's written policies, procedures, and other documentation associated with this activity are consistent with the Federal Reserve System's Examination Guidelines. If the bank does not have written policies the examiner should strongly advise that they be developed due to the complex nature of this activity and the potential risks associated with it.
    d. After reviewing the policies, procedures,

and appropriate documentation, the examiner should be able to respond positively to the following questions:

- Banking organizations acting as *agents in the sale of federal funds*[1]
  - — Has this form of activity been approved by the board of directors?
  - — Are the bank's individual agency arrangements and transactions:
    - supported by written agency agreements, and
    - reviewed and approved by appropriate officers?
  - — Do the written agency agreements that support this activity include provisions indicating that (a negative answer may indicate that the bank is not in fact an agent):
    - the agent bank will be acting *on behalf of the original or principal seller of federal funds ("seller")* in conducting these activities and not on the agent bank's own behalf?
    - the agency relationship will be fully disclosed to all banks involved in the transactions?
    - the seller, and not the agent bank, must retain legal title to the federal funds before they are sold to a third party bank?
    - the seller, and not the agent bank, bears the risk of loss?
    - the agent bank's authority in selling federal funds and in accounting for this activity to the seller should be controlled by the seller or by standards to which it has agreed? To implement this, does the agreement or its attachments include the following seller-approved items:
      1. lists of banks to whom the agent may sell federal funds,[2] and
      2. limits on the amounts that can be sold to these banks?
  - — Does the agent have a written opinion from its legal counsel as to the bona fide nature of the agency relationship?
  - — Does the accounting and reporting system of the agent bank *enable* it to account for the federal funds transactions on a period basis (i.e., at least weekly) to the sellers? (Although more frequent accounting may not be required by the sellers, the agent on any day should have the capacity to identify for the seller the banks to whom the seller's funds have been sold.)
  - — Does the agent's accounting system identify *each bank* which has purchased federal funds from a particular seller bank and include (at least) the following information for *each bank* in which the funds are being invested?[3]
    - information to clearly identify the name and location of the bank (or other entity)
    - amount of federal funds sold and amount of interest earned
    - terms of transaction, and maturity date
    - lending limits agreed to
  - — Does the agent bank actually disclose to banks or other organizations that are part of these agency-based transactions that it is acting as agent?
  - — Is the agent bank's compensation in the form of a predetermined fee schedule or percentage rate based, for example, on the size of transactions, as opposed to compensation in the form of a spread over the rate that it pays to the seller bank? (If the agent bank's compensation is in the form of a spread over the rate it pays to the selling bank, this situation would appear to be more akin to acting as an intermediary and suggests that the

1. Although it is conceivable that a purchaser could engage an agent to *obtain* federal funds on its behalf, these guidelines focus primarily on situations where the seller has engaged an agent to sell federal funds on its behalf because the associated risks of such transactions are borne by the sellers and their agents.
2. Seller banks could conceivably design their lists of approved banks to encompass a large number of financially sound institutions and still be considered to be fulfilling this supervisory requirement.
3. The entities referred to as "ultimate purchasers" or "ultimate borrowers" are those that have the *responsibility to repay* the original seller bank, and not any intervening agents that may pass on the federal funds to these purchasers.

transactions should be reported on its balance sheet.)

- Banking organizations that are involved in agency-based federal funds relationships as *sellers*
  - — Does the bank support its transactions with written agency agreements?
  - — Does the seller bank evaluate the credit worthiness of the ultimate borrowers of federal funds and establish limits for each and are these limits periodically reviewed at least every six months?[3,4]
  - — Does the bank periodically (i.e., at least weekly) receive an accounting from the agent which includes the following information for *each bank* to whom the seller bank's federal funds were sold?
    - information to identify name and location of bank
    - amount of federal funds sold and interest earned
    - federal funds sales limits agreed to (if the seller bank is a principal)
  - — Is the bank's management and board of directors aware of and have they approved the agency relationship?
- Do internal and/or external auditors periodically review the policies, procedures, and internal controls associated with this activity and the activity's impact on the earnings and financial condition of the banking organization? Is their evaluation reported to management? (Applies to banks acting as *agents* in the sale of federal funds, *and* those banks involved as *sellers* of federal funds.)
- In addition to the items considered above, the examiner should determine what the impact of these transactions has been on the bank's earnings and financial condition. If the impact has been negative, or if the answer to any of the above questions is negative, the examiner should discuss these matters with bank management and seek remedial action.

14. Analyze the effectiveness of operational controls by reviewing recent cancellations and fail items that are a week or more beyond settlement date and determine:
    a. The amount of extended fails.
    b. The planned disposition of extended fails.
    c. If the control system allows a timely, productive follow-up on unresolved fails.
    d. The reasons for cancellations.
    e. The planned disposition of securities that have been inventoried prior to the recognition of a fail or a cancellation.
15. Determine compliance with applicable laws, rulings, and regulations by performing the following for:
    a. *12 CFR 1.3—Eligible Securities:*
       - Review inventory schedules of underwriting and trading accounts and determine if issues whose par value is in excess of 10 percent of the bank's captial and unimpaired surplus are type I securities.
       - Determine that the total par value of type II investments does not exceed 10 percent of the bank's capital and unimpaired surplus, based on the combination of holdings and permanent portfolio positions in the same securities.
       - Elicit management's comments and review underwriting records on direct placement of type III securities, and determine if the bank is dealing in type III securities for its own account by ascertaining if direct placement issues have been placed in own bank or affiliated investment portfolios or if underwriting proceeds were used to reduce affiliate loans.

    b. *Section 23A of the Federal Reserve Act (12 USC 371(c) and 375)—Preferential Treatment:* Obtain a list of domestic affiliate relationships and a list of directors and principal officers and their business interests from appropriate examiners and determine whether transactions, include securities clearance services, involving affiliates, insiders or their interests are on terms less favorable to the bank than those transactions involving unrelated parties.
    c. *Regulation D (12 CFR 204.2)—Due Bills:*

4. This requirement is intended to mean that seller banks should conduct the type of credit analysis that would be considered reasonable and prudent for a direct federal funds activity (i.e., those federal funds activities not conducted through agents).

- Review outstanding due bills and determine if:
  - — The customer was informed that a due bill would be issued instead of the purchased security.
  - — Safekeeping receipts are sent to safekeeping customers only after the purchased security has been delivered.
- Review due bills outstanding over three business days and determine if they are collateralized or properly reserved.
- Review collateralized due bills and determine if the liability is secured by securities of the same type and of comparable maturity and with a market value at least equal to that of the security that is the subject of the due bill.

d. *Regulation H (12 CFR 208.8(k))—Recordkeeping and Confirmation Requirements:* If the bank effects securities transactions at the direction and for the account of customers, determine if it is in compliance with this regulation by substantiating Internal Control questions 24–35.

16. Test for unsafe and unsound practices and possible violations of the Securities Exchange Act of 1934 by:
    a. Reviewing customer account schedules of own bank and affiliated bank permanent portfolios, trusts, other broker-dealers, employees of own or other banks and other broker-dealers. Use an appropriate technique to select transactions and compare trade prices to independently established market prices as of the date of trade.
    b. Reviewing transactions, including U.S. government tender offer subscription files, involving employees and directors of own or other banks and determine if the funds used in the transactions were misused bank funds or the proceeds of reciprocal or preferential loans.
    c. Reviewing sales to affiliated companies to determine that the sold securities were not subsequently repurchased at an additional mark-up and that gains were not recognized a second time.
    d. Reviewing commercial paper sales journals or confirmations to determine if the bank sells affiliate commercial paper. If so, determine if:
       - The bank sells affiliate-issued commercial paper to institutions and financially sophisticated individuals only.
       - Sales are generally denominated in amounts of $25,000 or more.
       - Each sale confirmation discloses that the affiliate-issued commercial paper is not an insured bank deposit.
    e. Reviewing securities position records and customer ledgers with respect to large volume repetitive purchase and sales transactions and:
       - Independently testing market prices of significant transactions which involve the purchase and resale of the same security to the same or related parties.
       - Investigating the purchase of large blocks of securities from dealer firms just prior to month end and their subsequent resale to the same firm just after the beginning of the next month.
    f. Reviewing lists of approved dealer firms and determining that the approval of any firm that handles a significant volume of agency transactions is based on competitive factors rather than deposit relationships.
    g. Reviewing customer complaint files and determining the reasons for such complaints.
17. Discuss with an appropriate officer and prepare report comments concerning:
    a. The soundness of trading objectives, policies and practices.
    b. The degree of legal and market risk assumed by trading operations.
    c. The effectiveness of analytical, reporting and control systems.
    d. Violations of law.
    e. Internal control deficiencies.
    f. Apparent or potential conflicts of interest.
    g. Other matters of significance.
18. Reach a conclusion regarding the quality of department management and state your conclusions on the management brief provided by the examiner assigned ''Management Assessment.''
19. Update workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures regarding bank dealer activities. The bank's system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

This section applies to all bank dealer activities except those involving municipal securities, which are reviewed as part of a separate and distinct Municipal Bond Dealer Examination.

SECURITIES UNDERWRITING TRADING POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written securities underwriting/trading policies that:
   a. Outline objectives?
   b. Establish limits and/or guidelines for:
      - Price mark-ups?
      - Quality of issues?
      - Maturity of issues?
      - Inventory positions (including when issued (WI) positions)?
      - Amounts of unrealized loss on inventory positions?
      - Length of time an issue will be carried in inventory?
      - Amounts of individual trades or underwriter interests?
      - Acceptability of brokers and syndicate partners?
   c. Recognize possible conflicts of interest and establish appropriate procedures regarding:
      - Deposit and service relationships with municipalities whose issues have underwriting links to the trading department?
      - Deposit relationships with securities firms handling significant volumes of agency transactions or syndicate participations?
      - Transfers made between trading account inventory and investment portfolio(s)?
      - The bank's trust department acting as trustee, paying agent, and transfer agent for issues which have an underwriting relationship with the trading department?
   d. State procedures for periodic, monthly or quarterly, valuation of trading inventories to market value or to the lower of cost or market price?
   e. State procedures for periodic independent verification of valuations of the trading inventories?
   f. Outline methods of internal review and reporting by department supervisors and internal auditors to insure compliance with established policy?
   g. Identify permissible types of securities?
   h. Ensure compliance with the rules of fair practice that:
      - Prohibit any deceptive, dishonest or unfair practice?
      - Adopt formal suitability checklists?
      - Monitor gifts and gratuities?
      - Prohibit materially false or misleading advertisements?
      - Adopt a system to determine the existence of possible control relationships?
      - Prohibit the use of confidential, nonpublic information without written approval of the affected parties?
      - Prohibit improper use of funds held on another's behalf?
      - Allocate responsibility for transactions with own employees and employees of other dealers?
      - Require disclosure on all new issues?
   i. Provide for exceptions to standard policy?
2. Are the underwriting/trading policies reviewed at least quarterly by the board to determine their adequacy in light of changing conditions?
3. Is there a periodic review by the board to assure that the underwriting/trading department is in compliance with its policies?

OFFSETTING RESALE AND REPURCHASE TRANSACTIONS

4. Has the board of directors, consistent with its duties and responsibilities, adopted written offsetting repurchase transaction policies that:
   a. Limit the aggregate amount of offsetting repurchase transactions?
   b. Limit the amounts in unmatched or extended (over 30 days) maturity transactions?
   c. Determine maximum time gaps for unmatched maturity transactions?
   d. Determine minimumly acceptable interest rate spreads for various maturity transactions.
   e. Determine the maximum amount of funds to be extended to any single or related firms through reverse re-po transactions, involving unsold (through forward sales) securities?
   f. Require firms involved in reverse re-po transactions to submit corporate resolutions stating the names and limits of individuals, who are authorized to commit the firm?
   g. Require submission of current financial information by firms involved in reverse re-po transactions?
   h. Provide for periodic credit reviews and approvals for firms involved in reverse re-po transactions?
   i. Specify types of acceptable offsetting repurchase transaction collateral (if so, indicate type ___________).
5. Are written collateral control procedures designed so that:
   a. Collateral assignment forms are used?
   b. Collateral assignments of registered securities are accompanied by powers of attorney signed by the registered owner?
      - Registered securities are registered in bank or bank's nominee name when they are assigned as collateral for extended maturity (over 30 days) reverse re-po transactions?
   c. Funds are not disbursed until reverse re-po collateral is delivered into the physical custody of the bank or an independent safekeeping agent?
   d. Funds are only advanced against predetermined collateral margins or discounts?
      - If so, indicate margin or discount percentage ___________.
   e. Collateral margins or discounts are predicated upon:
      - The type of security pledged as collateral?
      - Maturity of collateral?
      - Historic and anticipated price volatility of the collateral?
      - Maturity of the reverse re-po agreements?
   f. Maintenance agreements are required to support predetermined collateral margin or discount?
   g. Maintenance agreements are structured to allow margin calls in the event of collateral price declines?
   h. Collateral market value is frequently checked to determine compliance with margin and maintenance requirements (if so, indicate frequency _________)?

CUSTODY AND MOVEMENT OF SECURITIES

*6. Are the bank's procedures such that persons do not have sole custody of securities in that:
   a. They do not have sole physical access to securities?
   b. They do not prepare disposal documents that are not also approved by authorized persons?
   c. For the security custodian, supporting disposal documents are examined or adequately tested by a second custodian?
   d. No person authorizes more than one of the following transactions: execution of trades, receipt and delivery of securities, and collection or disbursement of payment?
7. Are securities physically safeguarded to prevent loss, unauthorized disposal or use? And:
   a. Are negotiable securities kept under dual control?
   b. Are securities counted frequently, on a surprise basis, reconciled to the securities record, and the results of such counts reported to management?

   c. Does the bank periodically test for compliance with provisions of its insurance policies regarding custody of securities?
   d. For securities in the custody of others:
      - Are custody statements agreed periodically to position ledgers and any differences followed up to a conclusion?
      - Are statements received from brokers and other dealers reconciled promptly, and any differences followed up to a conclusion?
      - Are positions for which no statements are received confirmed periodically, and stale items followed up to a conclusion?

8. Are trading account securities segregated from other bank owned securities or securities held in safekeeping for customers?

*9. Is access to the trading securities vault restricted to authorized employees?

10. Do withdrawal authorizations require countersignature to indicate security count verifications?

11. Is registered mail used for mailing securities, and are adequate receipt files maintained for such mailings (if registered mail is used for some but not all mailings, indicate criteria and reasons)?

12. Are prenumbered forms used to control securities trades, movements and payments?

13. If so, is numerical control of prenumbered forms accounted for periodically by persons independent of those activities?

14. Do alterations to forms governing the trade, movement, and payment of securities require:
   *a. Signature of the authorizing party?
   b. Use of a change of instruction form?

15. With respect to negotiability of registered securities:
   a. Are securities kept in non-negotiable form whenever possible?
   b. Are all securities received, and not immediately delivered, transferred to the name of the bank or its nominee and kept in non-negotiable form whenever possible?
   c. Are securities received checked for negotiability (endorsements, signature, guarantee, legal opinion, etc.) and for completeness (coupons, warrants, etc.) before they are placed in the vault?

RECORDS MAINTENANCE

16. Does the bank maintain:
   a. Order tickets which include:
      - Capacity as principal or agent?
      - If order is firm or conditional?
      - Terms, conditions or instructions and modifications?
      - Type of transaction (purchase or sale)?
      - Execution price?
      - Description of security?
      - Date and time of order receipt?
      - Date and time of execution?
      - Dealer’s or customer’s name?
      - Delivery and payment instructions?
      - Terms, conditions, date and time of cancellation of an agency order?
   b. Customer confirmations:
      - Bank dealer’s name, address and phone number?
      - Customer’s name?
      - Designation of whether transaction was a purchase from or sale to the customer?
      - Par value of securities?
      - Description of securities, including at a minimum:
        — Name of issuer?
        — Interest rate?
        — Maturity date?
        — Designation, if securities are subject to limited tax?
        — Subject to redemption prior to maturity (callable)?
        — Designation, if revenue bonds and the type of revenue?
        — The name of any company or person in addition to the issuer who is obligated, directly or indirectly, to pay debt service on revenue bonds? (In the case of more than one such obligor, the phrase “multiple obligors” will suffice.)
        — Dated date, if it affects price or interest calculations?
        — First interest payment date, if other than semi-annual?
        — Designation, if securities are “fully registered” or “registered as principal”?
        — Designation, if securities are “pre-refunded”?

  - Designation, if securities have been "called," maturity date fixed by call notice and amount of call price?
  - Denominations of bearer bonds, if other than denominations of $1,000 and $5,000 par value?
  - Denominations of registered bonds, if other than multiples of $1,000 par value up to $100,000 par value?
  - Denominations of municipal notes?
- Trade date and time of execution, or a statement that time of execution will be furnished upon written request of the customer?
- Settlement date?
- Yield and dollar price? Only the dollar price need to be shown for securities traded at par.
  - For transactions in callable securities effected on a yield basis, the resulting price calculated to the lowest of price to call premium, par option (callable at par) or to maturity, and if priced to premium call or par option, a statement to that effect and the call or option date and price used in the calculation?
- Amount of accrued interest?
- Extended principal amount?
- Total dollar amount of transaction?
- The capacity in which the bank dealer effected the transaction:
  - As principal for own account?
  - As agent for customer?
  - As agent for a person other than the customer?
  - As agent for both the customer and another person (dual agent)?
- If a transaction is effected as agent for the customer or as dual agent:
  - Either the name of the contra-party or a statement that the information will be furnished upon request?
  - The source and amount of any commission or other remuneration to the bank dealer?
- Payment and delivery instructions?
- Special instructions, such as:
  - "Ex-legal" (traded without legal opinion)?
  - "Flat" (traded without interest)?
  - "In default" as to principal or interest?

c. Dealer confirmations:
- Bank dealer's name, address and telephone number?
- Contra-party identification?
- Designation of purchase from or sale to?
- Par value of securities?
- Description of securities, including at a minimum:
  - Name of issuer?
  - Interest rate?
  - Maturity date?
  - Designation, if securities are limited tax?
  - Subject to redemption prior to maturity (callable)?
  - Designation, if revenue bonds and the type of revenue?
  - Dated date, if it affects price or interest calculations?
  - First interest payment date, if other than semi-annual?
  - Designation, if securities are "fully registered" or "registered as principal"?
  - Designation, if securities are "pre-refunded"?
  - Designation, if securities have been "called," maturity date fixed by call notice and amount of call price?
  - Denominations of bearer bonds, if other than denominations of $1,000 and $5,000 par value?
  - Denominations of registered bonds, if other than multiples of $1,000 par value up to $100,000 par value?
- CUSIP number, if assigned (effective January 1, 1979)?
- Trade date?
- Settlement date?
- Yield to maturity and resulting dollar price? Only the dollar price need be shown for securities traded at par or on a dollar basis.
  - For transactions in callable securities effected on a yield basis, the resulting price calculated to the lowest of price to call premium, par option (callable at par) or to maturity?

    - If applicable, the fact that securities are priced to premium call or par option and the call or option date and price used in the calculation?
  - Amount of accrued interest?
  - Extended principal amount?
  - Total dollar amount of transaction?
  - Payment and delivery instructions?
  - Special instructions, such as:
    - ''Ex-legal'' (traded without legal opinion)?
    - ''Flat'' (traded without interest)?
    - ''In default'' as to principal or interest?

d. Purchase and sale journals or blotters which include:
  - Trade date?
  - Description of securities?
  - Aggregate par value?
  - Unit dollar price or yield?
  - Aggregate trade price?
  - Accrued interest?
  - Name of buyer or seller?
  - Name of party received from or delivered to?
  - Bond or note numbers?
  - Indication if securities are in registered form?
  - Receipts or disbursements of cash?
  - Specific designation of ''when issued'' transactions?
  - Transaction or confirmation numbers recorded in consecutive sequence to insure that transactions are not omitted?
  - Other references to documents of original entry?

e. Short sale ledgers which include:
  - Sale price?
  - Settlement date?
  - Present market value?
  - Basis point spread?
  - Description of collateral?
  - Cost of collateral or cost to acquire collateral?
  - Carrying charges?

f. Security position ledgers, showing separately for each security positioned for the bank's own account:
  - Description of the security?
  - Posting date (either trade or settlement date, provided posting date is consistent with other records of original entry)?
  - Aggregate par value?
  - Cost?
  - Average cost?
  - Location?
  - Count differences classified by the date on which they were discovered?

g. Securities transfer or validation ledgers which include:
  - Address where securities were sent?
  - Date sent?
  - Description of security?
  - Aggregate par value?
  - If registered securities:
    - Present name of record?
    - New name to be registered?
  - Old certificate or note numbers?
  - New certificate or note numbers?
  - Date returned?

h. Securities received and delivered journals or tickets which include:
  - Date of receipt or delivery?
  - Name of sender and receiver?
  - Description of security?
  - Aggregate par value?
  - Trade and settlement dates?
  - Certificate numbers?

i. Cash or wire transfer receipt and disbursement tickets which include:
  - Draft or check numbers?
  - Customer accounts debited or credited?
  - Notation of the original entry item that initiated the transaction?

j. Cash or wire transfer journals which additionally include:
  - Draft or check reconcilements?
  - Daily totals of cash debits and credits?
  - Daily proofs?

k. Fail ledgers which include:
  - Description of security?
  - Aggregate par value?
  - Price?
  - Fail date?
  - Date included on fail ledger?
  - Customer or dealer name?
  - Resolution date?
  - A distinction between a customer and a dealer fail?
  - Follow-up detail regarding efforts to resolve the fail?

l. Securities borrowed and loaned ledgers which include:
  - Date of transaction?
  - Description of securities?

- Aggregate par value?
- Market value of securities?
- Contra-party name?
- Value at which security was loaned?
- Date returned?
- Description of collateral?
- Aggregate par value of collateral?
- Market value of collateral?
- Collateral safekeeping location?
- Dates of periodic valuations?

m. Records concerning written or oral put options, guarantee and repurchase agreements which include:
- Description of the securities?
- Aggregate par value?
- Terms and conditions of the option, agreement or guarantee?

n. Customer account information which includes:
- Customer's name and residence or principal business address?
- Whether customer is of legal age?
- Occupation?
- Name and address of employer? And:
  - — Whether customer is employed by a securities broker or dealer or by a municipal securities dealer?
- Name and address of beneficial owner or owners of the account if other than customer? And:
  - — Whether transactions are confirmed with such owner or owners?
- Name and address of person(s) authorized to transact business for a corporate, partnership or trusteed account? And:
  - — Copy of powers of attorney, resolutions or other evidence of authority to effect transactions for such an account?
- With respect to borrowing or pledging securities held for the accounts of customers:
  - — Written authorization from the customer authorizing such activities?
- Customer complaints including:
  - — Records of all written customer complaints?
  - — Record of actions taken concerning those complaints?

o. Customer and the bank dealer's own account ledgers which include:
- All purchases and sales of securities?
- All receipts and deliveries of securities?
- All receipts and disbursements of cash?
- All other charges or credits?

p. Records of syndicates' joint accounts or similar accounts formed for the purchase of municipal securities which include:
- Underwriter agreements? And:
  - — Description of the security?
  - — Aggregate par value of the issue?
- Syndicate or selling group agreements? And:
  - — Participants' names and percentages of interest?
  - — Terms and conditions governing the formation and operation of the syndicate?
  - — Date of closing of the syndicate account?
  - — Reconcilement of syndicate profits and expenses?
- Additional requirements for syndicate or underwriting managers which include:
  - — All orders received for the purchase of securities from the syndicate or account, except bids at other than the syndicate price?
  - — All allotments of securities and the price at which sold?
  - — Date of settlement with the issuer?
  - — Date and amount of any good faith deposit made with the issuer?

q. Files which include:
- Advertising and sales literature
- Prospectus delivery information?

r. Internal supervisory records which include:
- Account reconcilement and follow-up?
- Profit analysis by trader?
- Sales production reports?
- Periodic open position reports computed on a trade date or when issued basis?
- Reports of own bank credit extensions used to finance the sale of trading account securities?

PURCHASE AND SALES TRANSACTIONS

17. Are all transactions promptly confirmed in writing to the actual customers or dealers?
18. Are confirmations compared or adequately tested to purchase and sales memoranda and reports of execution of orders, and any differences investigated and corrected (including approval by a designated responsible employee)?
    a. Are confirmations and purchase and sale memoranda checked or adequately tested for computation and terms by a second individual?
19. Are comparisons received from other dealers or brokers compared with confirmations, and any differences promptly investigated?
    a. Are comparisons approved by a designated individual (if so, give name __________)?

CUSTOMER AND DEALER ACCOUNTS

20. Do account bookkeepers periodically transfer to different account sections or otherwise rotate posting assignments?
21. Are letters mailed to customers requesting confirmation of changes of address?
22. Are separate customer account ledgers maintained for:
    - Employees?
    - Affiliates?
    - Own bank's trust accounts?
23. Are customer inquiries and complaints handled exclusively by designated individuals who have no incompatible duties?

RECORDKEEPING AND CONFIRMATION REQUIREMENTS FOR CUSTOMER SECURITIES TRANSACTIONS (REGULATION H)

24. Are chronological records of original entry containing an itemized daily record of all purchases and sales of securities maintained?
25. Do the original entry records reflect:
    a. The account or customer for which each such transaction was effected?
    b. The description of the securities?
    c. The unit and aggregate purchase or sale price (if any)?
    d. The trade date?
    e. The name or other designation of the broker-dealer or other person from whom purchased or to whom sold?

If the bank has had an average of 200 or more securities transactions per year for customers over the prior three-calendar-year period, exclusive of transactions in U.S. government and federal agency obligations, answer questions 26, 27 and 28.

26. Does the bank maintain account records for each customer which reflect:
    a. All purchases and sales of securities?
    b. All receipts and deliveries of securities?
    c. All receipts and disbursements of cash for transactions in securities for such account?
    d. All other debits and credits pertaining to transactions in securities?
27. Does the bank maintain a separate memorandum (order ticket) of each order to purchase or sell securities (whether executed or cancelled) which includes:
    a. The account(s) for which the transaction was effected?
    b. Whether the transaction was a market order, limit order, or subject to special instructions?
    c. The time the order was received by the trader or other bank employee responsible for affecting the transaction?
    d. The time the order was placed with the broker-dealer, or if there was no broker-dealer, the time the order was executed or cancelled?
    e. The price at which the order was executed?
    f. The broker-dealer used?
28. Does the bank maintain a record of all broker-dealers selected by the bank to effect securities transactions and the amount of commissions paid or allocated to each such broker during the calendar year?
29. Does the bank, subsequent to effecting a securities transaction for a customer, mail or otherwise furnish to such customer either a copy of the confirmation of a broker-dealer relating to the securities transaction or a written trade confirmation

of a broker-dealer relating to the securities transaction or a written trade confirmation prepared by the bank?

30. If customer notification is provided by furnishing the customer with a copy of the confirmation of a broker-dealer relating to the transaction, and if the bank is to receive remuneration from the customer or any other source in connection with the transaction, and the remuneration is not determined pursuant to a written agreement between the bank and the customer, does the bank also provide a statement of the source and amount of any remuneration to be received?
31. If customer notification is provided by furnishing the customer with a trade confirmation prepared by the bank, does the confirmation disclose:
    a. The name of the bank?
    b. The name of the customer?
    c. Whether the bank is acting as agent for such customer, as principal for its own account, or in any other capacity?
    d. The date of execution and a statement that the time of execution will be furnished within a reasonable time upon written request of such customer?
    e. The identity, price and number of shares of units (or principal amount in the case of debt securities) of such securities purchased or sold by such customer?
32. For transactions which the bank effects in the capacity of agent, does the bank, in addition to the above, disclose:
    a. The amount of any remuneration received or to be received, directly or indirectly, by any broker-dealer from such customer in connection with the transaction?
    b. The amount of any remuneration received or to be received by the bank from the customer and the source and amount of any other remuneration to be received by the bank in connection with the transaction, unless remuneration is determined pursuant to a written agreement between the bank and the customer?
    c. The name of the broker-dealer used. Where there is no broker-dealer, the name of the person from whom the security was purchased or to whom it was sold, or the fact that such information will be furnished within a reasonable time upon written request?
33. Does the bank maintain the above records and evidence of proper notification for a period of at least three years?
34. Does the bank furnish the written notification described above within five business days from the date of the transaction, or if a broker-dealer is used, within five business days from the receipt by the bank of the broker-dealer’s confirmation? If not, does the bank use one of the alternative procedures described in Regulation H?
35. Unless specifically exempted in Regulation H, does the bank have established written policies and procedures ensuring:
    a. That bank officers and employees who make investment recommendations or decisions for the accounts of customers, who particpate in the determination of such recommendations or decisions, or who, in connection with their duties, obtain information concerning which securities are being purchased or sold or recommended for such action, report to the bank, within 10 days after the end of the calendar quarter, all transactions in securities made by them or on their behalf, either at the bank or elsewhere in which they have a beneficial interest (subject to certain exemptions)?
    b. That in the above required report the bank officers and employees identify the securities purchased or sold and indicate the dates of the transactions and whether the transactions were purchases or sales?
    c. The assignment of responsibility for supervision of all officers or employees who (1) transmit orders to or place orders with broker-dealers, or (2) execute transactions in securities for customers?
    d. The fair and equitable allocation of securities and prices to accounts when orders for the same security are received at approximately the same time and are placed for execution either individually or in combination?
    e. Where applicable, and where permissible under local law, the crossing of buy and sell orders on a fair and equitable basis to the parties to the transaction?

OTHER

36. Are the preparation, additions, and posting of subsidiary records performed and/or adequately reviewed by persons who do not also have sole custody of securities?
37. Are subsidiary records reconciled, at least monthly, to the appropriate general ledger accounts and are reconciling items adequately investigated by persons who do not also have sole custody of securities?
38. Are fails to receive and deliver under a separate general ledger control?
    a. Are fail accounts periodically reconciled to the general ledger, and any differences followed up to a conclusion?
    b. Are periodic aging schedules prepared (if so, indicate frequency __________)?
    c. Are stale fail items confirmed and followed up to a conclusion?
    d. Are stale items valued periodically and, if any potential loss is indicated, is a particular effort made to clear such items or to protect the bank from loss by other means?
39. With respect to securities loaned and borrowed positions:
    a. Are details periodically reconciled to the general ledger, and any differences followed up to a conclusion?
    b. Are positions confirmed periodically (if so, indicate frequency ____________)?
40. Is the compensation of all department employees limited to salary and a non-departmentalized bonus or incentive plan?
    a. Are sales representatives' incentive programs based on sales volume and not department income?

CONCLUSION

41. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
42. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

This section will help the examiner perform two separate but related functions:

- the evaluation of the depth and scope of formalized policies and procedures used by the bank to manage and control its loan portfolio
- an overview of the performance of the entire lending operation by consolidating the results of the examination programs from the various lending departments

BANK LOAN POLICY

The purpose of a bank's lending policy is to establish the authority, rules, and framework to operate and administer its loan portfolio effectively; that is, to ensure profitability while managing risk. The policy serves as a framework to set basic standards and procedures in a clear and concise manner. The policy's guidelines should be derived from a careful review of internal and external factors that affect the institution, such as the bank's market position, historical experience, present and prospective trade area, probable future loan and funding trends, facilities, staff capabilities, and technology. Such guidelines, however, must be void of any discriminatory policies or practices.

The complexity and scope of the lending policy and procedures should be appropriate to the size of the institution and the nature of its activities, and should be consistent with prudent banking practices and relevant regulatory requirements. Examiners should keep in mind that a loan policy that is appropriate for one bank is not necessarily suitable for another bank. Each bank's policy will differ, given the institution's strategic goals and objectives, coupled with such factors as economic conditions, experience and ability of the lending personnel, and competition. The policy should be reviewed at least annually to ensure that it is not outdated or ineffective, remains flexible, and continues to meet the needs of the community. Changes in federal and other regulatory requirements also must be incorporated in the policy.

The policy should be broad and not overly restrictive. If carefully formulated and administered by senior management, and clearly communicated and understood through each level of the organization, it greatly helps bank management (1) maintain sound credit underwriting standards; (2) control and manage risk; (3) evaluate new business opportunities; and (4) identify, administer, and collect problem loans.

The lending policy must clearly state the philosophies and principles that govern safe and sound banking practices and procedures, as well as the mission and objectives of the particular institution. Throughout this manual, considerable emphasis is placed on formal written policies established by the board of directors that management can implement, administer, and amplify. The board of directors, in discharging its duty to both depositors and shareholders, must ensure that loans in the bank's portfolio are made based on the following three objectives:

- to grant loans on a sound and collectible basis
- to invest the bank's funds profitably for the benefit of shareholders and the protection of depositors
- to serve the legitimate credit needs of the bank's community

The written loan policy is the cornerstone for sound lending and loan administration. An adequate loan policy promotes—

- a bank's business and lending philosophy, despite changes in management;
- stability, as it provides a reference for lenders;
- clarity, to minimize confusion concerning lending guidelines; and
- sound objectives for evaluating new business opportunities.

The loan policy should define who will receive credit, what type, and at what price. Other internal factors to be addressed include who will grant the credit and in what amount, as well as what organizational structure will ensure compliance with the bank's guidelines and procedures. As loan authority is spread throughout the organization, the bank must have an efficient internal review and reporting system to monitor adherence to established guidelines. This system should adequately inform the directorate and senior management of how policies are being carried out and provide them with sufficient information to evaluate the performance of lending officers and the condition of the loan portfolio.

The loan policy should (1) establish what information will be required from the borrower during the application process, (2) what information the borrower will be required to submit while the credit remains outstanding, and (3) which bank personnel are responsible for obtaining the information. In addition, the policy should specify who is responsible for reviewing the adequacy of loan documentation and for citing and correcting documentation exceptions. A high level of documentation exceptions indicates a deficiency in the bank's policy, procedures, monitoring, or enforcement.

A loan policy will differ from loan procedures. A policy represents a plan, a guiding principle, or course of action designed to establish a framework for handling decisions, actions, and other matters, thereby influencing them. A procedure is a set of established methods or steps for performing a task. The lending policy should include issues relevant to all departments of the bank. Written procedures approved and enforced in various departments should be referenced in the bank's general lending policy. The policy must be flexible enough to allow for fast adaptation to changing conditions in the bank's earning assets mix and trade area.

Components of a Sound Lending Policy

As mentioned previously, a bank's loan policy should be appropriate to its size and complexity. However, sound loan policy generally is based on the components described below.

Allowance for Loan and Lease Losses—A sound lending policy establishes a systematic loan review program to detect and identify problem loans and other portfolio weaknesses. (See the ''Internal Loan Review'' subsection for the requirements of a loan review program.) Guidelines and methodologies need to be established to determine the adequacy of the bank's allowance for loan and lease losses (ALLL) and should be based on a conservative analysis of the risk contained in the loan portfolio. This analysis should therefore ensure that sufficient cushion is maintained to allow for the imprecision inherent in most estimates of expected credit losses. The Interagency Policy Statement on the Allowance for Loan and Lease Losses[1] stipulates that federally insured depository institutions must maintain an ALLL at a level that is adequate to absorb estimated credit losses associated with the loan and lease portfolio, including all binding commitments to lend.

Examiners must evaluate management's estimate of losses existing in the bank's loan portfolio, as well as the methodologies and procedures used in making the estimate. That evaluation provides the basis for determining the adequacy of a bank's allowance for loan and lease losses. (See the 2070 sections of this manual for further details.)

Collections and Charge-Offs—The lending policy should define the criteria and procedures for reporting to the board of directors relevant information concerning delinquent obligations. The policy should establish the mechanism for presenting problem loans to the directorate. Reports submitted to the board of directors should include sufficient detail for it to determine the risk factor, loss potential, and alternative courses of action. The policy should outline a follow-up collection-notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by the board of directors or a board committee for charge-off.

Concentrations of Credit—The lending policy should encourage both diversification within the portfolio and a balance between maximum yield and minimum risk. Concentrations of credit depend heavily on a key factor, and when weaknesses develop in that key factor, every individual loan within the concentration is affected. The directorate should evaluate the additional risk involved in various concentrations and determine which concentrations should be avoided or limited. The lending policy also should establish thresholds for acceptable concentrations of credit and require that all concentrations be reviewed and reported to the board on a periodic basis.

Institutions that have effective controls to manage and reduce undue concentrations over time need not refuse credit to sound borrowers simply because of the borrower's industry or geographic location. This principle applies to

1. See SR-93-70 (FIS)

prudent loan renewals and rollovers, as well as to new extensions of credit that are underwritten in a sound manner. (See the 2050 sections of this manual for further details.)

Consumer and Equal Credit Opportunity Laws—Compliance with the many consumer-related laws, regulations, rulings, interpretations, and policy statements requires complex and detailed policies and procedures that should be addressed in a separate policy. However, the loan policy should require adherence to the Federal Reserve's Regulation B, 12 CFR 202, which implements the Equal Credit Opportunity Act. This regulation prohibits creditors from discriminating against loan applicants on the basis of age, race, color, religion, national origin, sex, marital status, or receipt of income from public assistance programs. As additional prohibitions are added under the regulation, they should be incorporated into the policy statement. Also, the loan policy should include a requirement that the bank give applicants a written notification of rejection of a loan application, a statement of the applicant's rights under the Equal Credit Opportunity Act, and a statement either of the reasons for rejection or of the applicant's right to such information.

Credit Files—Obtaining and maintaining complete and accurate information on every relevant detail of a borrower's financial condition is essential to approving credit in a safe and sound manner. The loan policy should establish what information will be required from the borrower during the application process and what information the borrower will be required to submit while the credit remains outstanding. Credit files should be maintained on all borrowing relationships, regardless of size, with the exception of the latitude provided by the Interagency Policy Statement on Documentation of Loans. A current credit file should provide the loan officer, loan committee, and internal and external reviewers with all information necessary to analyze the credit before it is granted and to monitor and evaluate the credit during its life. Such information should (1) identify the borrower's business or occupation; (2) document the borrower's past and current financial condition; (3) state the purposes of all loans granted to the borrower, the sources of repayment, and the repayment programs; and (4) identify the collateral and state its value and the source of the valuation.

Credit files should include all financial statements, credit reports, collateral-inspection documents, reference letters, past loan applications, memoranda, correspondence, and appraisals. In many cases, particularly those involving real estate loans, appraisals and other collateral documentation may be maintained in a separate collateral file.

Documentation requirements will vary according to the type of loan, borrower, and collateral. For example, a bank may not require financial statements from borrowers whose loans are fully secured by certificates of deposit it issues. In a more general sense, information requirements between amortizing consumer loans and commercial or real estate loans vary greatly. More specific examples of the types and frequency of financial information often obtained for various types of credit are detailed in the following paragraphs.

For many consumer installment and residential mortgage loan borrowers, the borrowers' financial information generally is collected only at the time of loan application. The underwriting process for these types of loans emphasizes factors such as the borrower's income and job stability, credit history, and debt load, as well as the loan-to-value requirements for obtained collateral.

In factoring and other asset-backed lending activities, while financial information is a significant part of the underwriting process, collateral is the key component of the lending decision. Close monitoring of the collateral's existence, value, and marketability are essential to sound underwriting of these types of loans.

For typical commercial, commercial real estate, and agricultural loans, significant emphasis is placed on the financial strength, profitability, and cash flow of the core business for loan repayment. Close monitoring of the business's financial condition and profitability throughout the life of the loan is key to the sound administration of these types of credits. Other pertinent information requirements, such as collateral-inspection documentation for agricultural credits or lease/rental information for income-producing commercial real estate credits, may also be necessary to properly administer these loans. As part of the sound underwriting process for these loans, a bank may include loan covenants requiring the business to maintain financial soundness, submit periodic financial statements, and provide other needed information.

As a practice, a bank should not ask for information it does not need to adequately underwrite and monitor the quality of its loans. With proper use of loan covenants, a bank can protect its right to receive additional or more frequent information if a borrower's financial condition deteriorates or collateral values decline. When determining the financial and other information to request from the borrower, bankers should consider the requirements of the underwriting process for particular types of loans and the repayment risks. A bank's loan policy should clearly delineate the type and frequency of such information requirements.

The lending policy also should define the financial-statement requirements for businesses and individuals at various borrowing levels. Specifically, requirements for audited, unaudited, annual, or interim balance sheets; income and cash-flow statements; statements of changes in capital accounts; and supporting notes and schedules should be included, as appropriate. In addition, the lending policy should require external credit checks as appropriate, at the inception of the loan and during periodic updates. The loan policy should be written so that credit-data exceptions would be a violation of the policy.

Distribution by Category—Limitations based on aggregate percentages of total loans in commercial, real estate, consumer, or other categories are common. Aggregate percentages for loans to deposits, assets, and capital (with regard to concentrations of credit) would provide guidance for effective portfolio management. Such policies are beneficial but should allow for deviations, with the approval by the board or a board committee. This allows credit to be distributed in response to the community's changing needs. During times of heavy loan demand in one category, an inflexible loan-distribution policy would cause that category to be slighted in favor of another.

Exceptions to the Loan Policy—A lending policy should require loan officers to present credits they believe are fundamentally sound and worthy of consideration, even though they may not conform with the bank's written lending policy or procedures. The reason for the exception should be detailed in writing and submitted for approval to a designated authority. The directors' loan committee or a similar body should review and approve all exceptions at reasonable intervals. The frequency of exceptions granted may indicate a lessening of underwriting standards on the one hand, or a need to adjust the policy to allow flexibility within safe and sound parameters on the other. The underlying reasons behind frequently granted exceptions should be assessed, and appropriate recommendations should be made accordingly.

Financing Other Real Estate—If the bank wants to finance a parcel of other real estate that it owns, special accounting rules may apply. Consequently, the lending policy should include an outline of certain provisions of Financial Accounting Standards Board (FASB) Statement No. 66, ''Accounting for Sales of Other Real Estate.''

Geographic Limits—A bank's trade area should be clearly delineated and consistent with defined CRA criteria. Loan officers and directors should be fully aware of specific geographic limitations for lending purposes. The bank's defined trade area should not be so large that, given its resources, the bank cannot properly and adequately monitor and administer its credits. A sound loan policy restricts or discourages loan approval for customers outside the trade area. The bank's primary trade area should be distinguished from any secondary trade area, which is especially important for new banks. Specific restrictions or exceptions should be listed separately.

Lender Liability—Banking organizations must be careful that their actions to make, administer, and collect loans—including assessing and controlling environmental liability—cannot be construed as taking an active role in the management or day-to-day operations of the borrower's business. Such actions could lead to potential liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). (See ''Environmental Liability'' later in this section.)

Limitation on Aggregate Outstanding Loans—Banks should establish guidelines limiting the total amount of loans outstanding in relation to other balance-sheet accounts. This type of control over the loan portfolio usually is expressed relative to deposits and total assets. In setting such limitations, various factors, such as the credit demands of the community, the volatility of deposits, and the credit risks involved, must be considered.

Loan Authority—The lending policy should establish limits for all lending officers and ensure controls are in place to monitor compliance with the bank's legal lending limit. An individual officer's lending limit is usually based on his or her experience, tenure, and past adherence to the bank's loan policy. Lending limits also should be set for group authority, allowing a combination of officers or a committee to approve larger loans than the members would be permitted to approve individually. The loan policy should describe the manner in which loans will be approved and ultimately reported to the board of directors, as well as the frequency of any loan committee meetings, as applicable.

Loan Pricing—At a minimum, interest rates on loans must be sufficient to cover (1) the cost of the funds loaned, (2) the bank's loan services (including general overhead), and (3) probable losses—while providing for a reasonable profit margin. Policymakers must know these costs before establishing rates. Periodic review allows rates to be adjusted in response to changes in costs, competitive factors, or risks of a particular type of extension of credit. Specific guidelines for other relevant factors, such as compensating balance requirements and fees on commitments, are also germane to pricing credit.

Loan Purchases and Sales—If sufficient loan demand exists, lending within the bank's trade area is safer and less expensive than purchasing paper from a dealer or a correspondent bank. Direct lending promotes customer relationships, serves the credit needs of customers, and develops additional business. Occasionally, a bank may not be able to advance a loan to a customer for the full amount requested because of individual state lending limitations or other reasons. In such situations, the bank may extend credit to a customer up to its internal or legal lending limit, and sell a participation to a correspondent bank for the amount exceeding the bank's lending limit or the amount it wishes to extend on its own. Generally, such sales arrangements are established before the credit is ultimately approved. These sales should be on a nonrecourse basis by the bank, and the originating and purchasing banks should share in the risks and contractual payments on a pro-rata basis. Selling or participating out portions of loans to accommodate the credit needs of customers promotes goodwill, and enables a bank to retain customers who might otherwise seek credit elsewhere.

Conversely, many banks purchase loans or participate in loans originated by others. In some cases, such transactions are conducted with affiliates or members of a chain banking organization, with the goal of benefitting the whole organization. A purchasing bank also may wish to supplement its loan portfolio when loan demand is weak. In still other cases, a bank may purchase or participate in a loan to accommodate an unrelated originating bank with which it has an ongoing business relationship.

Purchasing or selling loans, if done properly, can have a legitimate role in a bank's overall asset and liability management and can contribute to the efficient functioning of the financial system. In addition, these activities help a bank diversify its risks and improve its liquidity.

Banks should avoid purchases of loans that generate unacceptable concentrations of credit. Such concentrations may arise solely from the bank's purchases, or they may arise when loans or participation purchased are aggregated with loans originated and retained by the purchasing bank. The policy should state the limits for the aggregate amount of loans purchased from and sold to any one outside source and of all loans purchased and sold. It should also establish limits for the aggregate amount of loans to particular types of industries. The extent of contingent liability, holdback and reserve requirements, and the manner in which loans will be handled and serviced should be clearly defined. In addition, the policy should require that loans purchased from another source be evaluated in the same manner as loans originated by the bank itself. Guidelines should be established for the type and frequency of credit and other information the bank needs to obtain from the originating institution to keep itself continually updated on the status of the credit. Guidelines also should be established for supplying complete and regularly updated credit information to the purchasers of loans originated and sold by the bank.

Loans to Employees, Officers, Directors, Principal Shareholders, and Their Related Interests—Loans to insiders are strictly defined in federal statutes and require close supervision to ensure compliance. Federal and state statutes provide the basis for defining insider loans, and they specify requirements and limitations that should be incorporated in the policy (see the Federal Reserve's Regulation O, 12 CFR 215).

The policy should ensure, through a system of controls over authority and funding, that extensions of credit to insiders are legally permissible and that they are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with other borrowers. Furthermore, the policy should contain guidelines for loans to employees who are not subject to the provisions of Regulation O.

Maximum Maturities—Loans should be granted with realistic repayment plans, with the maturity related to the anticipated source of repayment, the purpose of the loan, and the useful life of the collateral. For term loans, a lending policy should state the maximum number of months over which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and modification of original loan terms. If the bank requires a cleanup (out-of-debt) period for lines of credit, it should be stated explicitly.

Maximum Ratio of Loan Amount to Collateral Value—The loan policy should set forth procedures for ordering, preparing, and reviewing appraisals for real or personal property pledged as collateral. The bank's lending policy should outline guidelines for appraisals or internal evaluations, including regulatory requirements, and, in the case of renewals or extensions, procedures for possible reappraisals or reevaluations. Acceptable types of appraisals or evaluations should be outlined. Circumstances requiring the use of in-house staff appraisers instead of fee appraisers should be identified. Maximum loan-to-value ratios and the methods of valuation to be used for various types of collateral should be detailed. (See the 2090 and 2100 sections of this manual for further details.)

The maximum ratio of loan amount to the market value of pledged securities is restricted by the Federal Reserve's Regulation U, 12 CFR 221. The lending policy should set forth margin requirements for all types of securities acceptable as collateral. Margin requirements should be related to the marketability of the security, that is, whether it is actively traded, over the counter, or closely held. The policy also should assign responsibility and set a frequency for periodic pricing of the collateral.

Prohibitions Against Tying Arrangements—In a tying arrangement, the extension of credit, provision of a service, or consideration for credit or service generally is varied or conditioned upon a customer's obtaining or providing some additional product or service from or to the bank or an affiliate. Section 106(b) of the Bank Holding Company Act Amendments of 1970 generally prohibits a bank from tying a product or service to any of its other products or services, including those offered by its affiliates. Certain tying arrangements are permissible when the two products tied are loans, deposits, or trust services available from the same bank, or when the Board has determined that a particular tying arrangement is permissible.[2]

To the extent possible, examiners should ascertain that member banks have not extended credit voluntary or involuntary based on impermissible tying arrangements.

Types of Loans—The lending policy should state the types of loans management considers desirable or prohibited. It also should set forth guidelines for extensions of credit types such as commercial loans, real estate loans, secured and unsecured loans, and off-balance-sheet activities, such as letters of credit and loan commitments. The decision about the types of loans granted should be based on the expertise of the lending officers, the deposit structure of the bank, and the community's anticipated credit demands. Credits involving complex structures or repayment arrangements, or loans secured by collateral that requires more than normal monitoring, should be avoided unless the bank has the personnel, policies, controls, and systems necessary to administer such advances properly. Types of credits that have caused an abnormal loss to the bank should be identified, scrutinized, and controlled within the framework of stated policy. A bank also should consider its overall exposure to term lending relative to its stable funds.

Other—Management should establish appropriate policies, procedures, and information systems to ensure that the impact of the bank's lending activities on its interest-rate exposure is carefully analyzed, monitored, and managed. In this regard, consideration should also be given to off-balance-sheet instruments that may be associated with lending arrangements, including commitments, letters of credit, or swaps. (See the 4110 sections of this manual for further details.)

2. SR-92-41 (FIS)

Under the provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), a financial institution is required to develop, adopt, and maintain policies, procedures, and guidelines consistent with safe and sound banking practices. The federal banking agencies have issued interagency guidelines based on the provisions. Taken together, these guidelines should strengthen supervision of financial institutions and provide guidance in developing and maintaining policies:

- Interagency Policy Statement on Appraisal and Evaluation Guidelines[3]
- Interagency Policy Statement on Supervisory Initiatives/Credit Availability[4]
- Interagency Policy Statement on Allowance for Loan and Lease Losses[5]
- Interagency Policy Statement on Documentation of Loans[6]
- Interagency Guidance on Accounting for Disposition of Other Real Estate Owned[7]
- Interagency Policy Statement on Monitoring Program for the ''Exempt Portion'' of the Loan Portfolio[8]
- Supervisory Policy Regarding Prohibitions Against Tying Arrangements[9]

An institution's policies and procedures as they relate to interagency statements should be reviewed as part of the examination of the institution's overall lending activities.

LOAN ADMINISTRATION

Loan administration is a term that refers to several aspects of lending. It can be used to describe the entire credit-granting process, as well as the monitoring of various lending activities, such as ensuring that loans remain adequately collateralized, properly graded, and appropriately serviced (administered). The servicing of an extension of credit involves tasks ranging from obtaining current financial information to sending out renewal notices and preparing loan agreements. In addition to facilitating the entire lending process, the individual tasks also serve as controls (checks and balances) over the lending activities. Given the wide breadth of responsibilities that the loan administration function encompasses, its organizational structure varies with the size and sophistication of the bank. In larger banks, responsibilities for the various components of loan administration are usually assigned to different departments, while in smaller institutions, a few individuals might handle several of the functional areas. For example, a large bank's independent credit department may be responsible for analyzing borrowers' financial information, making a determination or recommendation as to the quality of the loan (its risk rating or grade), or obtaining/following up on credit-related information and documentation. On the other hand, smaller banks may assign each of these tasks to individual loan officers.

Examiners will encounter many different organizational structures for loan administration. Therefore, when considering the safety and soundness of a bank, they should determine whether it has effective and appropriate internal controls in place. The assessment of loan administration and related internal controls involves evaluating the bank's operations by reviewing the—

- efficiency and effectiveness of loan administration operations;
- ability of the different components to safeguard assets, primarily loans and leases;
- adequacy of the management information systems and accuracy of the systems' reporting;
- adequacy and accuracy of its loan review function (discussed in the next subsection); and
- compliance with prescribed management policies, procedures, applicable laws, and regulations.

For the components of loan administration to function appropriately, management must understand and demonstrate that it recognizes the importance of controls. This includes not only establishing appropriate policies and procedures, but also enforcing them and ensuring that the bank's organizational structure is suitable for its size and complexity. Managers should emphasize integrity and ethical values, as well as hire competent staff. In addition, the follow-

3. See SR-94-50 (FIS); SR-94-35 (FIS); SR-92-33 (FIS)
4. See SR-93-30 (FIS)
5. See SR-93-70 (FIS)
6. See SR-93-26 (IB)
7. See SR-93-42 (FIS)
8. See SR-93-34 (FIS)
9. See SR-92-41 (FIS)

ing factors positively influence loan administration control:

- a board of directors and/or senior management that takes an active role in monitoring lending policies and practices
- a reporting system that provides the bank with the information needed to manage the lending function and make sound credit decisions
- a well-defined lending approval and review system that includes established credit limits; limits and controls over the types of loans made; limits on maturities of loans; and policies on interest rates, pricing, and fee charges
- an independent loan review function that identifies and evaluates existing and potential problem loans in a timely manner
- an independent reporting system that notifies appropriate personnel when financial information, insurance policies, or other loan documentation needs to be obtained
- a system of procedures that correct documentation exceptions

Loan administration is responsible for mitigating the operational risks associated with loan-related transactions, such as approving credit, disbursing loan proceeds, receiving loan payments, recording accrued interest and fee income, posting to subsidiary ledgers, and reconciling subsidiary and general ledgers. Typically, employees working with these types of activities have the capability to transfer funds between accounts on the bank's and customer's behalf, which opens up an area of potential abuse. Additional potential areas for unethical employee behavior include the maintenance of loan notes and related documentation, as well as the credit and collateral files on borrowers. The bank must ensure it has adequate controls in place to avoid any improprieties; controls might include having separate departments for loan activities within a large organizational structure or rotating and/or segregating loan duties in smaller community banks. Some specific issues related to these responsibilities are described below.

Applications and Loan Approval Process

The bank should have written policies and procedures for obtaining and reviewing loan applications and for ensuring sufficient borrower information (both financial and collateral-related) is required and analyzed in support of the loan approval. Approvals should be made in accordance with the bank's written guidelines and should also address the disbursal of loan proceeds. Additional issues that bank policies and procedures should address include—

- the requirement that loan commitments be in writing;
- requirements for letters of credit;
- the requirement for an annual review of borrowers, including a reassessment of the appropriateness of credit lines; and
- the requirement for a process for extending or renewing loans and credit lines.

Exceptions to the bank's written policies and procedures should reflect the appropriate level of approval and should be documented in writing.

Account Records

Bank staff should compare the approved terms for new and renewed extensions of credit (amount, maturity, interest rate, payment schedule) to the note or loan agreement for accuracy. The former should then be compared to the trial balance, if it is automated. If a manual system is used, the approved amount of the extension of credit should be checked against deposit tickets to ensure the correct amount was transferred to the borrower's account. Adjustments to loan accounts or accrued interest receivable accounts should be checked and tested by an individual independent of the loan-processing area. Subsidiary records should be routinely reconciled with the appropriate general ledger accounts.

Payments

Regardless of the type of payment, principal, interest, or fee, certain controls are necessary to ensure the effectiveness of operations, as well as the safeguarding of bank assets. An individual who cannot originate loan entries should perform an independent test of interest, commissions, and fee computations and confirm their accuracy. Payment notices should be prepared by someone other than a loan teller. In addition, loan officers should be prohibited from processing loan payments. Payments received by mail, tellers, or other departments should be separate from the loan-recording function. Supervisory approvals should be required for processing payments that are less than the amount contractually due, pertain to delinquent loans, are received irregularly, or involve waiving late fees. Collection notices should also be handled by someone not associated with loan processing.

Credit File Documentation

The bank should establish and maintain credit files for all borrowers. The bank's written loan policy should detail the minimum acceptable amount of information to be included in a borrower's credit file. The credit file should contain information on the extension of credit that identifies its purpose, source of repayment, repayment terms, and disposition of loan proceeds. Additionally, information should be on file relating to and/or analyzing the borrower's financial condition, including tax returns as appropriate; collateral, its valuation and related hazard insurance; the loan officer's contact with the borrower; and other pertinent documents, such as guarantor information, loan agreements, and loan covenant check sheets. Banks should maintain this information to support their evaluation of the borrower's creditworthiness and to leave a paper trail for auditors. The bank should also implement a file documentation tickler system to help bank personnel obtain updated information on borrowers, thereby facilitating continuous assessment and monitoring of credit risk.

Collateral Records

Banks should maintain a register to document collateral received from and released to borrowers, which should correspond to the actual collateral being held. Negotiable collateral should be maintained under dual control in a fireproof vault. The receiving and releasing of collateral to customers should be handled by individuals other than those who make entries in the collateral register. The bank should issue a receipt to customers for each item of collateral it is holding in safekeeping. Signed customer receipts should be obtained and filed after the collateral is released.

Management Information Systems

Management information systems, an increasingly important component of the loan administration function, allow a bank to manage its lending decisions more efficiently and effectively. Whether the bank uses a computerized or manual system to manage its loan portfolio, the following types of information should be readily available and routinely reviewed by management:

- total loans and commitments
- loans in excess of existing credit limits
- new extensions of credit, credit renewals, and restructured credits
- a listing of all delinquent and/or nonaccrual loans
- credits adversely graded or requiring special attention
- credits to insiders and their related interests
- credits not in compliance with policies, laws, or regulations
- specific lending activity aspects, including automated financial statement spreads of borrowers and analyses of the bank's credit exposure by type, geographic areas, collateral, and large employers

INTERNAL LOAN REVIEW

The internal loan review function should not be merely an after-the-fact, loan-by-loan review, but a process to detect weaknesses in the various levels of an institution's credit approval and monitoring system.

The nature of loan review systems may vary based on an institution's size, complexity, and management practices. For example, a loan review system may include components of a traditional loan review function that is independent of the lending function. Or, it may place some reliance on loan officers. While the former method is preferred, reliance on the lending staff could be appropriate if the loan officers are not permitted sole discretion to assign credit-quality ratings. In addition, the term "loan review system" can refer to various responsibilities assigned to credit administration, loan administration, problem-loan workout, or other areas. These responsibilities may range from administering the internal problem loan–reporting process to maintaining the integrity of the credit-grading process (for example, ensuring that changes are made in credit grades as needed) and coordinating the information necessary to assess ALLL adequacy. Regardless of the structure of the loan review function, an effective system should—

- ensure consistent application of the credit-grading system,
- promptly and accurately identify loans with potential or well-defined credit weaknesses and ensure the development and implementation of an appropriate action plan to minimize credit losses,
- project relevant trends that affect the collectibility of the portfolio and isolate potential problem areas,
- act as an information source concerning emerging trends in the portfolio and the bank's area economy,
- provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio,
- provide essential information to determine the adequacy of the ALLL,
- assess the adequacy of and adherence to internal credit policies and loan administration procedures, and monitor compliance with relevant laws and regulations,
- ensure that relevant supporting loan documentation has been obtained,
- help develop and revise lending policy and procedures,
- evaluate the activities of lending personnel, and
- provide management with accurate and timely information related to credit quality that can be used for financial and regulatory reporting purposes.

Characteristics of Loan Review Program

To accomplish the preceding loan review objectives effectively, the program must possess the following components:

- a policy that clearly defines responsibilities of the loan review function and that communicates directorate and management support to all personnel involved in the lending function
- a policy that explicitly describes the bank's credit-grading system and grading definitions
- the capacity for objective judgment of loan quality and the autonomy to exercise it
- the freedom to communicate directly, without fear of reprisal, with senior management and the bank's board of directors
- skilled personnel who are experienced in credit analysis and knowledgeable of sound lending operations
- training and continuing education resources for the loan review staff

Credit-Grading Systems

The foundation of any loan review system is accurate and timely credit grading (also referred to as risk rating), which involves assessing credit quality and, ultimately, identifying problem loans. An effective credit-grading system provides that the bank's risk ratings on "non-pass" credits be updated periodically (at least quarterly) so that (1) the ALLL is appropriate for the risk contained in the portfolio and (2) strategies relative to workout action plans are up-to-date. Regardless of the type of loan review system employed, an effective credit-grading framework generally places primary reliance on loan officers to identify emerging loan problems. However, given the importance and the subjective nature of credit grading, a loan officer's judgment on the assignment of a particular credit grade to a loan should be subject to review by (1) peers, superiors, or loan committees; (2) an independent, qualified part-time or full-time person(s); (3) an internal department staffed with credit review specialists; or (4) outside credit review consultants. A review of the credit-quality assessment independent of the lending function is preferred because it typically provides a more conservative and realistic assessment of credit quality. Accurate and timely credit grading is a critical component of an effective loan review system. Each institution should ensure that its loan review system includes the following attributes:

- a formal credit-grading system that can be reconciled with the framework used by the federal regulatory agencies[10]

10. An institution may have a credit-grading system that differs from the credit-grading framework used by the Federal Reserve. However, each institution that maintains a credit-grading system that differs from the Federal Reserve's framework should maintain documentation that translates its credit-grading system into the pass/special mention/substandard/doubtful/loss credit-grading framework used by the Federal Reserve. This documentation should be sufficient to enable

- an identification or grouping of loans that warrants the special attention of management, with documentation supporting the reasons a particular loan deserves special attention
- a mechanism for direct, periodic, and timely reporting to senior management and the board of directors on the status of loans identified as needing special attention, and the actions taken by management
- appropriate documentation of the institution's credit loss experience for various components of its loan and lease portfolio[11]

An institution should maintain a written description of its credit-grading system, including a discussion of the factors used to assign appropriate credit grades to loans. Loan grades should reflect the risk of credit losses. In addition, the loan review program should be in writing, and the board of directors should review and approve it at least annually to evidence its endorsement.

Loan Review System Elements

An institution's written policy and documentation of its loan review system should address the following elements:

- qualifications of loan review personnel
- independence of loan review personnel
- frequency of reviews
- scope of reviews
- depth of reviews
- review of findings and follow-up
- workpaper and report distribution, including distribution of reports to senior management and the board of directors

Qualifications of Loan Review Personnel—Persons involved in the loan review function should be selected based on level of education, experience, and extent of formal credit training. They should be knowledgeable of both sound lending practices and the institution's lending guidelines for the types of loans it offers. In addition, loan review personnel should be aware of relevant laws and regulations affecting lending activities.

Independence of Loan Review Personnel—An effective loan review system uses (1) a loan officer's initial identification of emerging problem loans and (2) the credit review of loans by individuals independent of the credit approval decisions. The first element of an effective system recognizes the loan officer's responsibility to continually analyze his or her portfolio and to promptly identify and report problem loans. Due to their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to the nonlending staff. However, banks should not rely completely on loan officers for identification of problem loans because they may not be entirely objective in assessing the borrower's credit quality. The second element of an effective loan review system recognizes that loans should be reviewed by individuals that do not have responsibility for the loans they review and that the evaluation of the credit should not be influenced by anyone associated with the loan approval/management process.

While larger institutions typically establish a separate department of credit review specialists, cost and volume considerations may not justify such a system in smaller institutions. As a result, in many smaller institutions, management, a loan committee, or even loan officers may fill this role—or it may be filled by outside consultants who periodically come to the bank and review parts or all of the loan portfolio. Whether or not the institution has an independent loan review department, the loan review function should report directly to the board of directors or a board committee. (Senior management may be responsible for appropriate administrative functions as long as the independence of the loan review function is not compromised.)

Frequency of Reviews—Optimally, the loan review function provides useful, continual feedback on the effectiveness of the lending process to identify any emerging problems. For example, significant credits should be reviewed at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality of a borrower or a particular type of loan or pool of loans. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL

examiners to reconcile the totals for the various credit grades under the institution's system to the Federal Reserve's categories listed above.

11. Institutions are encouraged to maintain records of net credit loss experience for credits in each of the following categories: pass, special mention, substandard, doubtful, and loss.

determination process, which depends on the accurate and timely identification of problem loans.

Scope of Reviews—The review should cover all borrowers whose exposure is significant to the size of the bank. Additionally, each review should typically include the following components of the portfolio under review: a sample of smaller loans; past-due, nonaccrual, renewed, and restructured loans; loans previously classified or designated as special mention by the institution or its examiners; insider loans; and concentrations of credit, including other loans affected by common repayment factors. It is important that the scope-related information indicates that these components have been included in the review of the portfolio and that the percentage of the portfolio selected for review provides reasonable assurance that review results identify major problems in that portion of the portfolio and accurately reflect its quality. On a larger scale, the scope of management's review of the entire loan portfolio should attest to the fact that its reviews identify problem loans significant to the bank and accurately reflect portfolio quality on an ongoing basis. The scope of loan reviews should be approved annually by the institution's board of directors or when significant changes are made to the scope.

Depth of Reviews—Reviews should analyze a number of important aspects of selected loans, including—

- credit quality;
- sufficiency of credit and collateral documentation;
- proper lien perfection;
- proper approval by the loan officer and loan committee(s);
- adherence to any loan-agreement covenants;
- compliance with laws, regulations, and internal policies and procedures; and
- the appropriateness and timeliness of problem-loan identification by loan officers.

Review of Findings and Follow-Up—Findings should be reviewed with appropriate loan officers, department managers, and members of senior management. Management's responses to all noted deficiencies and identified weaknesses should include existing or planned corrective actions and the timeframes for correction. Significant noted deficiencies and identified weaknesses that remain unresolved beyond the assigned correction timeframes should be promptly reported to senior management and, if still unresolved, to the board of directors.

Workpaper and Report Distribution—Workpapers should contain a list of the borrowers included in the scope of the review and all supporting information needed to substantiate the findings. Reports to management discussing the findings of a portfolio review should indicate the "as of" review date; address the credit grading (risk rating) of the individual borrowers (loans) reviewed, as well as of the specific portfolio; assess the adequacy of and adherence to internal policies and procedures; indicate loan, credit file, and collateral deficiencies; and evaluate compliance with laws and regulations. The reports also should include summary analyses supporting the assignment of special-mention or classified designations to borrowers (loans). A summary report to the board of directors should be submitted at least quarterly and include findings relative to the areas previously mentioned for all reviews conducted during that timeframe (more frequently if material adverse trends are noted.) This summary report might include, in addition to the issues found in the reports to management, comparative trends identifying significant changes in the overall quality of the portfolio.

Examination Scope Guidance

An effective loan review function can greatly assist examiners in their review of the bank's loan portfolio. The examination process should evaluate the internal loan-review function by assessing the scope and depth of the review and the quality of the output. While examiners should not rely entirely on the bank's findings, they can limit the scope of their loan examination by developing a comfort level with the bank's internal loan-review function. To determine the reliability, if any, of the internal loan-review function, examiners should assess the adequacy of management's ability to identify problem loans. Two issues should be evaluated in this regard: timeliness and accuracy. The first issue deals with the ability of loan review to distinguish a problem loan and/or borrower from a nonproblem one when it initially becomes a problem. The second issue deals with the accuracy of loan review in identifying the severity of the problem. The Extent that examiners rely on an internal loan-review function depends upon their comfort level with the bank in the aforementioned regard.

The examiner will be able to determine the degree to which the bank's loan review function can be relied upon by reviewing prior examination criticisms, as well as management's response to them, and a sufficient sample of the bank's portfolio. Whether the borrower being reviewed as a part of the sampling process is a pass or nonpass credit, examiners should consider narrowing the scope of the pass credits included in the loan examination if they concur with the bank's risk ratings. However, examiners still should continue their analysis of all ''nonpass'' credits due to their importance to the adequacy of the ALLL.

NONACCRUAL LOANS

Loans and lease-financing receivables are to be placed on nonaccrual status if (1) principal or interest has been in default for 90 days or more, unless the loan is both well secured and in the process of collection; (2) payment in full of principal or interest is not expected; or (3) they are maintained on a cash basis because the financial condition of the borrower has deteriorated.

Definition of ''well secured'' and ''in the process of collection''—A debt is ''well secured'' if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full or (2) by the guarantee of a financially responsible party. A debt is ''in the process of collection'' if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or (2) through collection efforts (not involving legal action) that are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future. Statutory bad debt, ''A paper,'' is defined in section 5204 of the U.S. Revised Statutes (12 USC 56) as all debts to a bank on which interest is past due and unpaid for six months, unless the same is well secured and in the process of collection. Delinquent loans that are not covered under the definition of statutory bad debt are designated ''B paper.''

Exceptions—A loan does *not* need to be placed on nonaccrual status if (1) the criteria for amortization specified in AICPA Practice Bulletin No. 6 are met with respect to a loan acquired at a discount from an unaffiliated third party, including those that the seller has maintained on nonaccrual status, or (2) the loan is a consumer loan or secured by a one- to four-family residential property. However, the bank may elect to carry these loans on a nonaccrual status. Also, if a bank has a significant consumer or residential mortgage loan portfolio in relation to its total loans and tier 1 capital, a thorough review of the delinquency status should be performed to ensure that the bank has not materially misstated its financial condition and earnings.

Treatment of Cash Payments and Criteria for the Cash-Basis Treatment of Income—When a bank places a loan on nonaccrual status, it must consider how to account for subsequent payments. When the collectibility of the remaining book balance of a loan on nonaccrual status is uncertain, any payments received must be applied to reduce principal to the extent necessary to eliminate such doubt. Placing an asset on nonaccrual status does not require a charge-off, in whole or in part, of the asset's principal. However, *any identified loss* must be charged off.

When a loan is on nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis, as long as the remaining book balance of the asset after the charge-off, if any, is deemed fully collectible. A bank's determination of the collectibility of an asset's remaining book balance must be supported by a current, well-documented credit evaluation of the borrower's financial condition and repayment prospects.

When recognition of interest income on a cash basis is appropriate, the amount of income recognized should be limited to what would have been accrued on the loan's remaining book balance at the contractual rate. Any cash interest payments received over this limit (and not applied to reduce the loan's remaining book balance) should be recorded as recoveries of prior charge-offs until these charge-offs have been fully recovered. (A bank should have a well-defined policy governing the treatment of interest income and the charge-off of accrued interest receivables.)

Treatment of Previously Accrued But Uncollected Interest—When a bank places a loan on nonaccrual status, its policy should address an appropriate treatment of previously accrued but uncollected interest. One acceptable method is to reverse all previously accrued but uncollected interest against appropriate income and balance-sheet accounts. For interest accrued in the current accounting period, the entry is made directly against the interest income account. For prior accounting periods, if accrued-interest provisions to the ALLL were not made, the amount of accrued but uncollected interest should be charged against current earnings. Also for prior accounting periods when provisions to the ALLL for possible loss of interest had been made, the bank generally reverses the accrued but uncollected interest by charging the ALLL to the extent of those specific provisions. Generally accepted accounting principles do not require the write-off of previously accrued interest if principal and interest are ultimately protected by sound collateral values. A bank is expected to have a well-defined policy, subject to examiner review, governing the write-off of accrued interest.

Treatment of Multiple Extensions of Credit to One Borrower—As a general rule, nonaccrual status for an asset should be determined by assessing its collectibility, repayment ability, and performance. Thus, when one loan to a borrower is placed in nonaccrual status, a bank does not automatically have to place all of that borrower's other extensions of credit in nonaccrual status. The bank should evaluate its other extensions of credit to that borrower to determine if one or more of them also should be placed in nonaccrual status.

Restoration to Accrual Status—As a general rule, a nonaccrual loan may be restored to accrual status when (1) its principal and interest are no longer past due and unpaid, and the bank expects repayment of the remaining principal and interest, or (2) when it otherwise becomes well secured and in the process of collection. Before restoring a loan to accrual status, the bank should consider the borrower's prospects for continuing future contractual payments. If reasonable doubt exists, reinstatement may not be appropriate.

To meet the first test, the bank must have received payment of the past-due principal and interest, unless the loan has been formally restructured and qualifies for accrual status under the restructured terms, or the asset has been acquired at a discount from an unaffiliated third party due to uncertainty about the amounts or timing of future cash flows and meets the amortization criteria (that is, accretion of discount) specified in AICPA Practice Bulletin No. 6.

A nonaccrual loan is considered in the process of collection if the borrower has resumed paying contractual interest and principal payments, even if the past-due amount has not been brought totally current. These loans may be returned to accrual status provided two criteria are met: All principal and interest amounts due (including arrearages) are reasonably assured of repayment within a reasonable period, and the borrower has a sustained period of performance (generally a minimum of six months) in accordance with the contractual terms.

Until the loan is restored to accrual status, cash payments received must be treated according to the criteria stated above. In addition, after a formal restructuring, if the loan that has been returned to accrual status later meets the criteria for placement in nonaccrual status (as a result of past-due status based on its modified terms or for any other reason), the asset must be placed on nonaccrual status.

Treatment of Nonaccrual Loans with Partial Charge-Offs—GAAP and regulatory reporting requirements do not explicitly address whether partial charge-offs associated with a nonaccrual loan (that has not been formally restructured) must be fully recovered before a loan can be restored to accrual status.

According to call report instructions, restoration to accrual status is permitted when (1) the loan has been brought fully current with respect to principal and interest and (2) the bank expects the loan's full contractual balance (including any amounts charged off), plus interest, will be fully collectible under the terms of the loan. Thus, to return a partially charged-off loan that has been brought fully current to accrual status, the bank should determine if it expects to receive the full amount of principal and interest called for by the loan's terms.

When the contractual principal and interest of a loan have been brought fully current, and the borrower's financial condition and repayment prospects have improved so that the full contractual principal (including any amounts charged off) and interest is expected to be repaid, the loan may be restored to accrual status *without* having to first recover the charge-off. Conversely, this treatment would be inappropriate when the charge-off indicates continuing doubt about the collectibility of principal or interest.

The reasons for restoring a partially charged-off loan to accrual status must be documented. These actions should be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including any amounts charged off) and interest. This documentation will be subject to review by examiners.

Examiner Review—Some states have promulgated regulations or adopted policies for nonaccrual of interest on delinquent loans that may differ from the above procedures. In these cases, the bank should comply with the more restrictive policy. The examiner should ensure that the bank is complying with such guidelines. In all cases, each bank should formulate its own policies to ensure that net income is not being overstated. These policies are subject to examiner review.

RESTRUCTURED OR RENEGOTIATED ''TROUBLED'' DEBT

In a ''troubled-debt restructuring,'' a bank grants a borrower concessions (for example, a reduction of interest or principal payments) that it would not otherwise consider for economic or legal reasons related to a borrower's financial difficulties. Renegotiated ''troubled'' debt includes those loans and lease-financing receivables restructured or renegotiated to provide concessions to the borrower. A loan extended or renewed at a stated rate equal to the current interest rate for new debt with similar risk is not considered renegotiated debt. For further information, see the instructions for the Reports of Condition and Income; FASB Statement No. 15, ''Accounting by Debtors and Creditors for Troubled Debt Restructurings''; and FASB Statement No. 114, ''Accounting by Creditors for Impairment of Loan,'' which amends FASB 15 to require creditors to measure all loans that are restructured in a troubled-debt restructuring involving only a modification of terms in accordance with FASB 114.[12]

A bank should develop a policy for renegotiated troubled debt to ensure that such items are identified, monitored, and properly accounted for and controlled. These restructurings should occur infrequently. If not, the bank is probably experiencing significant problems. Before troubled-debt concessions are made to a borrower, it is a good practice to have the transactions receive prior approval of the board of directors or a board committee. All these transactions should be reported to the board of directors upon enactment.

Bankers may be involved in formally restructuring loans when borrowers experience financial difficulties or in light of the borrower's condition and repayment prospects. These actions, if consistent with prudent lending principles and supervisory practices, can improve a bank's collection prospects. GAAP and regulatory reporting requirements provide a reporting framework that may alleviate some of the lender's concerns about working constructively with borrowers experiencing financial difficulties. The accounting standards for troubled-debt restructurings are set forth in FASB Statement No. 15.

The interagency policy statement on credit availability, issued March 1, 1991, clarifies a number of supervisory policies on restructured-loan issues. Two of these clarifications indicate that when certain criteria are met, (1) nonaccrual assets can be restored to accrual status when subject to formal restructurings in accordance with FASB Statement No. 15, and (2) restructurings that yield a market rate of interest would not have to be included in restructured loan

12. FASB establishes a new approach for recognizing impairment on problem loans and new disclosure requirements for impaired loans for financial reporting purposes. FASB 118 amends FASB 114 to allow creditors to use existing methods for recognizing interest income on impaired loans. This statement also clarifies the existing accounting for in-substance foreclosure. Under the new impairment standard and related amendments to FASB 15, a collateral-dependent real estate loan (i.e., a loan for which repayment is expected to be provided solely by the underlying collateral) would be reported as OREO only if the lender has taken possession of the collateral. For other collateral-dependent real estate loans, loss recognition would be based on the fair value of the collateral if foreclosure is probable. However, these loans would no longer be reported as OREO. Rather, they would remain in the loan category. In light of the significance of these changes to accounting standards, the Federal Reserve is reevaluating regulatory disclosure and nonaccrual requirements and expects to issue revised policies at a later date. (See SR-93-30 (FIS).)

amounts reported in the years following the restructuring. These clarifications, which are consistent with GAAP, have been fully incorporated into the instructions for the Reports of Condition and Income (call reports).

Nonaccrual Assets Subject to FASB Statement No. 15 Restructurings

A loan or other debt instrument that has been formally restructured to ensure repayment and performance need not be maintained in nonaccrual status. In deciding whether to return an asset to accruing status, payment performance that had been sustained for a reasonable time before the restructuring may be considered. For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. It may be that the amount and frequency of payments under the restructured terms do not exceed those of the payments that the borrower had made over a sustained period, within a reasonable time before the restructuring. In this situation, if the lender is reasonably assured of repayment and performance according to the modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether before or after the date of the restructuring, is very important in determining whether there is reasonable assurance of repayment and performance. In certain circumstances, other information may be sufficient to demonstrate an improvement in the borrower's condition or in economic conditions that may affect the borrower's ability to repay. This information may reduce the need to rely on the borrower's performance to date in assessing repayment prospects. For example, if the borrower has obtained substantial and reliable sales, lease, or rental contracts or if other important developments are expected to significantly increase the borrower's cash flow and debt-service capacity and strength, then the borrower's commitment to repay may be sufficient. A preponderance of such evidence may be sufficient to warrant returning a restructured loan to accrual status. The restructured terms must reasonably ensure performance and full repayment.

It is imperative that the reasons for restoring restructured debt to accrual status be documented. A restoration should be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for repayment. This documentation will be reviewed by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways that will improve the likelihood that the credit will be repaid in full in accordance with reasonably restructured repayment terms. A restructured loan may not be restored to accrual status unless there is reasonable assurance of repayment and performance under its modified terms in accordance with a reasonable repayment schedule. Regulatory reporting requirements and GAAP do *not* require a banking organization that restructures a loan to grant excessive concessions, forgive principle, or take other steps not commensurate with the borrower's ability to repay to use the reporting treatment specified in FASB Statement No. 15. Furthermore, the restructured terms may include prudent contingent payment provisions that permit an institution to obtain appropriate recovery of concessions granted in the restructuring, if the borrower's condition substantially improves.

Moreover, while restructured debt that qualifies for accrual status and yields a market rate of interest must be disclosed as a FASB Statement No. 15 troubled debt in the year of the restructuring, it need not be disclosed in subsequent years. This clarification was particularly important because, while this guidance is derived from FASB Statement No. 15 and is generally followed for Securities and Exchange Commission reporting purposes, previously it was not clear that this treatment could be followed for call report purposes.

Reporting Guidance on Loan Fees and Interest

The accounting standards for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or group of loans are set forth in FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases." In general, this statement says loan-origination fees should be deferred and recognized over the life of the related loan as an adjustment of yield. The statement applies to all types of loans, as well as to debt securities (but not to loans or securities carried at market value), and to all types of lenders. It must be applied to all lending and leasing transactions in fiscal years beginning after December 15, 1987. Earlier application is encouraged, and retroactive application is permitted. For further information, see FASB Statement No. 91 and instructions for preparing the Report of Condition and Income.

TRANSFER OF LOW-QUALITY LOANS OR OTHER ASSETS

Low-quality loans include those classified or specially mentioned at the most recent examination or loans that would most likely be classified or specially mentioned if subjected to a review. In addition, low-quality loans include past-due loans, nonaccrual loans, loans on which the terms have been renegotiated because of a borrower's poor financial condition, and any other loans the examiner believes are questionable. Other assets of questionable quality include depreciated or subinvestment-grade securities and other real estate. A low-quality asset shall not be acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of an affiliate. Furthermore, a low-quality asset cannot be involved in a loan participation or an asset swap.

The transfer of low-quality loans or other assets from one depository institution to another may raise supervisory concerns. These transfers may be made to avoid detection and classification during regulatory examinations and may be accomplished through participation, purchases/sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Section 23A of the Federal Reserve Act, 12 USC 371c, prohibits bank purchases of low-quality assets from an affiliate. Examiners should be alert to situations in which an institution's intention appears to be concealing low-quality assets to avoid examiners' scrutiny and possible classification.

During bank examinations, examiners are requested to identify situations when low-quality assets have been transferred between the institution being examined and another depository institution. The transfer of assets to avoid supervisory review is a highly improper and unsound banking practice and, if an affiliate is involved, is a violation of section 23A of the Federal Reserve Act. If necessary, it should be addressed through formal supervisory enforcement action.

Any transfers of low-quality or questionable assets should be brought to the attention of Reserve Bank supervisory personnel. In turn, these individuals should notify the local offices of primary federal and state regulators (if applicable) of the other depository institutions involved in the transaction. For example, Reserve Banks should notify the primary federal and state regulators (if applicable) of any depository institution to which a state member bank or holding company is transferring or has transferred low-quality loans. Reserve Banks should also notify the primary federal and state regulators (if applicable) of any depository institution from which a state member bank or holding company is acquiring or has acquired low-quality loans. This procedure applies to transfers involving savings and loan associations, savings banks, and commercial banking organizations.

If the examiner determines a permissible transfer of assets was undertaken, he or she should ensure the assets have been properly recorded at fair market value on the books of the acquiring institution. If the transfer involved the parent holding company or a nonbank affiliate, the examiner should determine if the transaction also was recorded properly on the affiliate's books.[13]

Whenever asset transfers occur, examiners should determine whether the assets in question were independently and completely evaluated for conformance with bank policy and procedures. Examiners should be guided by the inspection procedures outlined in section 2020.7.2 of the *Bank Holding Company Supervision Manual*.

ENVIRONMENTAL LIABILITY

Banks may be liable for cleaning up hazardous substance contamination under both federal and state environmental liability statutes. This liability can arise through a bank's ownership or acquisition of real estate, in its role as a creditor, or in a fiduciary role. Banks may also be exposed to environmental liability indirectly through the increased possibility that a borrower's creditworthiness may be impaired by a liability to pay for cleanup of contaminated property, even if the property does not secure bank debt.

13. See SR-83-24 (FIS).

The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), the federal superfund statute, authorizes the Environmental Protection Agency (EPA) to clean up hazardous waste sites and to recover costs associated with the cleanup from entities specified in the statute. While the superfund statute is the primary federal law dealing with hazardous substance contamination, numerous other federal and state statutes establish environmental liability that could place banks at risk.

CERCLA defines who is subject to liability for the costs of cleaning up hazardous substance contamination. The definition includes ''. . . the owner and operator of a vessel or a facility, (or) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of . . . .''[14] Under the statute, a person or entity that transports or arranges to transport hazardous substances can also be held liable for cleaning up contamination.

The superfund statute imposes a standard of strict liability, which means the government does not have to prove that the owners or operators knew about or caused the hazardous substance contamination in order for them to be liable for the cleanup costs. Moreover, liability under the statute is joint and several, which allows the government to seek recovery of the entire cost from any individual party that is liable for those costs under CERCLA.

CERCLA provides an exemption for secured creditors in the definition of ''owner and operator'' by stating that these terms do not include ''. . . a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility.''[15] However, this exception has not provided banks with an effective defense from liability because courts have limited its applicability. Specifically, courts have held that some lenders' actions to protect their security interests have resulted in the bank ''participating in the management of a vessel or facility,'' thereby voiding the exemption. Additionally, once the title to a foreclosed property passes to the bank, some courts have held that the exemption no longer applies and that the bank is liable under the superfund statute as an ''owner'' of the property. Under some circumstances, CERCLA may exempt landowners who acquire property without knowing about existing conditions (the ''innocent landowner defense''). However, the courts have applied a stringent standard to qualify for this defense. Since the statute provides little guidance as to what constitutes the appropriate timing and degree of due diligence to successfully employ this exemption, banks should exercise caution before relying on it.

14. CERCLA, section 107(a).
15. CERCLA, section 101(20)(A).

Overview of Environmental Hazards

Environmental risk can be characterized as adverse consequences that result from generating or handling hazardous substances or from being associated with the aftermath of contamination.

Hazardous substance contamination is most often associated with industrial or manufacturing processes that involve chemicals as ingredients or waste products. For years, these types of hazardous substances were frequently disposed of in landfills or dumped on industrial sites. However, hazardous substances are also found in many other lines of business. The following examples demonstrate the diverse sources of hazardous substances, but by no means cover them all:

- farmers and ranchers (fuel, fertilizers, herbicides, insecticides, and feedlot runoff)
- dry cleaners (various cleaning solvents)
- service station and convenience store operators (underground storage tanks)
- fertilizer and chemical dealers and applicators (storage and transportation of chemicals)
- lawn care businesses (application of lawn chemicals)
- trucking firms (transportation of substances such as fuel or chemicals)

Environmental liability has had the greatest impact on the real estate industry. Not only has land itself been contaminated with toxic substances, construction methods for projects such as commercial buildings have used materials that have been subsequently determined to be hazardous—resulting in significant declines in project values. For example, asbestos was commonly used in commercial construction from the 1950s to the late 1970s. Asbestos has since been found to be a health hazard and now, in many cases, must be removed or its effects abated by enclosing or otherwise sealing off the contaminated areas.

Another common source of hazardous substance contamination is underground storage tanks. Leaks from these tanks not only contaminate the surrounding ground, but often flow into ground water and travel a significant distance from the original contamination site. As contamination spreads to other sites, cleanup costs escalate.

Effect on Banks—A bank may encounter losses from environmental liability through direct ownership, lending and trust activities, or mergers or acquisitions of borrowers. The greatest risk to a bank is the possibility of being held solely liable for costly environmental cleanups. Under the doctrine of joint and several liability, a bank may find itself solely responsible for cleaning up a contaminated site at a cost that exceeds any outstanding loan balance or property value.

Direct Ownership

A bank may be held liable for the cleanup of hazardous substance contamination in situations when it—

- takes title to property through foreclosure or acquires property to satisfy debts previously contracted;
- owns or acquires for future expansion premises that have been contaminated by hazardous substances; or
- owns, acquires, or merges with another entity involved in activities that might result in a finding of environmental liability.

Lending Activity—While real estate loans present the greatest risk, almost any type of loan, unsecured or secured, can expose a bank to the effects of environmental liability. A borrower who is required to pay for the cleanup of a contaminated property may be unable to provide the necessary funds both to remove contaminated materials and to service the debt. Even if the bank does not have a security interest in the borrower's real estate, it must be aware that significant cleanup costs could threaten the borrower's solvency and net worth (and jeopardize the collection of working-capital or equipment loans). If the loan is secured by the contaminated real estate, the bank may find that the property value has declined dramatically, depending on the degree of contamination. In determining whether to foreclose, the bank must compare the estimated cleanup costs against the value of the collateral. In many cases, this estimated cost has been well in excess of the outstanding loan balance, and the bank has elected to abandon its security interest in the property and charge off the loan. This situation occurs because some courts have not allowed banks that have foreclosed on a property to avail themselves of the secured-creditor exemption. These rulings have been based on a strict reading of the superfund statute that provides the exemption to ‘‘security interests’’ only.

A bank may also expose itself to environmental liability in its role as a secured or unsecured creditor if it involves bank personnel or contractors engaged by the bank in day-to-day management of the facility or takes actions designed to make the contaminated property salable, possibly resulting in further contamination.

Bank Premises—Banks may also be exposed to environmental liability for property held as bank premises. A review of historical uses of properties to be acquired for relocation or future expansion should provide insight into the likelihood that contamination may have occurred and whether additional steps may be warranted.

Mergers and Acquisitions of Borrowers—Borrowers may face environmental risk through the activities of subsidiaries or by merging with or acquiring other companies whose activities result in environmental liability. Some courts have held that for the purposes of determining liability under the superfund statute, the corporate veil may not protect parent companies that participate in the day-to-day operations of their subsidiaries from environmental liability and court-imposed cleanup costs. Additionally, borrowers and, ultimately, banks can be held liable for contamination that occurred before they owned or used the real estate.

Protection Against Environmental Liability

Banks may avoid or mitigate potential environmental liability by having sound policies and procedures designed to identify, assess, and control environmental liability. The following discussion briefly describes methods that banks may employ to minimize potential environmental liability.

Loan policies and procedures should address methods for identifying potential environmental problems relating to credit requests. The loan policy should describe an appropriate degree of due diligence investigation required for credit requests. Borrowers in high-risk industries or localities should be investigated more stringently than borrowers in low-risk industries or localities.

After a loan is granted, periodic credit analysis of the borrower's ability to repay should include an assessment of environmental risk. If the credit is secured by real property collateral, the bank should remain aware of the property's uses and the potential environmental risk associated with those uses. Even if the credit is not secured by real property, periodic credit reviews should determine whether repayment prospects may be jeopardized by any activities that might expose the borrower to environmental liability.

The first step in identifying environmental risk is an environmental review. These reviews may be performed by loan officers or others. They typically identify past uses of the property; evaluate regulatory compliance, if applicable; and identify potential problems. The reviewer should interview persons familiar with present and past uses of the facility and property, review relevant records and documents, and inspect the site.

When the environmental review reveals possible hazardous substance contamination, an environmental assessment or audit may be required. Environmental assessments are made by personnel trained in identifying potential environmental hazards and provide a more thorough inspection of the facility and property. Environmental audits differ markedly from environmental assessments because independent environmental engineers are employed to investigate the property in great detail. Engineers test for hazardous substance contamination, which might require collecting and analyzing air samples, surface soil samples, or subsurface soil samples or drilling wells to sample ground water.

Other measures some banks use to help identify and minimize environmental liability to the bank include obtaining indemnities from borrowers for any cleanup costs incurred by the bank and writing affirmative covenants into loan agreements (and attendant default provisions) that require the borrower to comply with all applicable environmental regulations. Although these measures may provide some aid in identifying and minimizing potential environmental liability, their effectiveness depends on the financial strength of the borrower and does not represent a substitute for environmental reviews, assessments, and audits.

Banks must be careful that any policies and procedures undertaken to assess and control environmental liability cannot be construed as taking an active role in the management or day-to-day operations of the borrower's business. Some activities that courts could consider active participation in the management of the borrower's business and that could subject the bank to potential liability include—

- having bank employees serve as members of the borrower's board of directors or actively participate in board decisions,
- assisting in day-to-day management and operating decisions, and
- actively determining management changes.

These considerations are especially important when the bank is actively involved in loan workouts or debt restructuring.

LOAN PROBLEMS

The failure of directors to establish a sound lending policy, require management to establish adequate written procedures, and monitor and administer the lending function within established guidelines has resulted in substantial problems for many institutions. Loan problems may be caused by a number of factors affecting the bank or its borrowers. For a discussion of the indicators of troubled commercial real estate loans, see the 2090 sections of this manual. The major sources and causes of problem credits are explained below.

Competition—Competition among banks for size and community influence may result in compromising credit principles and making or acquiring unsound loans. The ultimate cost of unsound loans always outweighs temporary gains in growth and influence.

Complacency—The following items manifest complacency and should always be guarded against:

- lack of adequate supervision of long-term and familiar borrowers

- dependence on oral information the borrower furnished in lieu of reliable and verifiable financial data
- optimistic interpretation of known credit weaknesses based on past survival of recurrent hazards and distress
- ignorance or disregard of warning signs about the borrower, economy, region, industry, or other related factors

Compromise of Credit Principles—Bank management, for various reasons, may grant loans carrying undue risks or unsatisfactory terms, with full knowledge of the violation of sound credit principles. The reasons management may compromise basic credit principles include timidity in dealing with individuals with dominating personalities or influential connections, friendships, or personal conflicts of interest. Self-dealing, salary incentives, and bonuses based on loan portfolio growth, as well as competitive pressures also may lead to a compromise of credit principles.

Failure to Obtain or Enforce Repayment Agreements—Loans granted without a clear repayment agreement are, at the very least, a departure from fundamental banking principles. These loans are likely to become significant problems. A more common problem, but just as undesirable, occurs when the bank and borrower agree on repayment or progressive liquidation of a loan, but the bank fails to collect the principal payments when and how it should. A study of loan losses will show that, in many cases, amortization never equalled the principal payments the borrower agreed to make. Good lending and good borrowing both require consistent liquidation.

Incomplete Credit Information—Complete credit information is necessary to make a reasonable and accurate determination of a borrower's financial condition and repayment capacity. Adequate and comparative financial statements, operating statements, and other pertinent statistical data should be available. Other essential information, such as the purpose of the borrowing and the intended plan and repayment source, progress reports, inspections, and memoranda of outside information and loan conferences, should be contained in the bank's credit files. The lack of adequate credit information can limit management's ability to react quickly and effectively when problems develop.

Lack of Supervision—Many loans that are sound at their inception develop into problems and losses because of ineffective supervision. This lack of supervision usually results from a lack of knowledge about the borrower's affairs over the lifetime of the loan.

Overlending—In one sense, overlending could come under the heading of technical incompetence. However, overlending is a weakness found in some lenders that are otherwise competent. Loans beyond the borrower's reasonable capacity to repay are unsound. Nowhere are technical competence and credit judgment more important than in determining a sound borrower's safe, maximum loan level.

Poor Selection of Risks—When banks are willing to assume more than normal risk levels, they often experience serious loan problems. The following general loan types may fall within the category of poor risk selection:

- loans in which the bank advances an excessive proportion of the required capital relative to the borrower's equity investment
- loans based more on the expectation of successfully completing a business transaction than on the existing net worth and repayment capacity
- loans for the speculative purchase of securities or goods
- loans collateralized by marketable assets carried without adequate margins of security
- loans made for other benefits, such as control of large deposit balances in the bank, instead of sound net worth, collateral, or repayment capacity
- loans secured solely by the nonmarketable stock of a local corporation, made in conjunction with loans directly to that corporation (The bank may consider itself forced to finance the corporation far beyond warranted limits to avoid loss on a loan that relies on the corporation's stock.)
- loans predicated on collateral of uncertain liquidation value (A moderate amount of these loans, when recognized by bank management as subject to inherent weakness, may cause few problems. However, the bank can encounter trouble if this practice becomes the rule.)

Revenue-Driven Lending—The loan portfolio is usually a bank's most important revenue-producing asset. The earnings factor, however, must never compromise sound credit judgment and allow credits carrying undue risks or unsatisfactory repayment terms to be granted. Unsound loans usually cost far more than the revenue they produce.

Self-Dealing—Self-dealing is found in many serious problem banks. Self-dealing often takes the form of an overextension of credit on an unsound basis to directors or principal shareholders, or to their related interests, who have improperly used their positions to obtain funds in the form of unjustified loans (or sometimes as fees, salaries, or payments for goods or services). Officers, who hold their positions at the pleasure of the board may be pressured to approve loan requests by insiders that, coming from customers, would have been rejected. In that situation, management may attempt to defend unsound loans or other self-dealing practices by bank insiders.

Technical Incompetence—All able and experienced bankers should possess the technical ability to analyze financial statements and to obtain and evaluate other credit information. When this ability is absent, unwarranted losses are certain to develop. Credit incompetence of management should be discussed promptly with the board of directors.

LOAN BROKERAGE AND SERVICING ACTIVITIES

Loan brokerage and servicing activities are undertaken by mortgage banking enterprises and the mortgage banking operations of commercial banks. Mortgage banking activities consist primarily of two separate but related activities: (1) the origination or acquisition of mortgage loans and the sale of the loans to permanent investors and/or (2) the subsequent long-term servicing of the loans. A mortgage banking enterprise usually retains the right to service mortgage loans it sells to permanent investors. An enterprise's right to service mortgage loans other than its own is an intangible asset that may be acquired separately. The rights to service mortgage loans are purchased and sold frequently. Mortgage loans are acquired to sell to permanent investors from a variety of sources, including applications received directly from borrowers (in-house originations), purchases from brokers, purchases from investors, and conversions of various forms of interim financing to permanent financing. A service fee, usually based on a percentage of the outstanding principal balance of the mortgage loan, is received for performing loan-administration functions. When servicing fees exceed the cost of performing servicing functions, the existing contractual right to service mortgage loans has economic value.

A number of bank services may result in assets and liabilities that do not have to be entered on the general ledger. These services are considered off-balance-sheet activities and may include the origination, sale, and servicing of various loans. Servicing and accounting activities cover functions related to initially recording the loan, collecting and recording payments, and reporting loan transactions and balances (including reporting past-due loans). Unlike the other activities in this section, servicing and accounting activities are not directly related to credit risk. However, some aspects of accounting and servicing activities, such as the accounting system's ability to produce accurate past-due loan reports, indirectly contribute to controlling credit risk. Also, poorly designed or ineffective servicing and accounting activities can contribute to increased risk in areas besides credit, such as fraud and insider abuse.

The origination, sale, and servicing of various types of loans usually have been associated with mortgage loans. But increasingly, origination and servicing activity has also been observed in government-guaranteed loans (or portions thereof), consumer loans, and commercial loans. Improper management and control of these activities by the servicer presents certain supervisory concerns. If the bank servicer is continually originating additional loans to be serviced, the bank may find itself responsible for servicing more loans than it can prudently manage. Failure to properly administer loans may lead to legal or financial liabilities that could adversely affect the bank's capital.

Examiners should review the extent and nature of servicing activities to ensure that they are conducted in a safe and sound manner. Loan-origination fees and related direct loan-origination costs of loans held-for-sale should be capitalized as part of the carrying amount of the related loan and should not be amortized. A premium paid for the right to service loans ordinarily is capitalized and equivalent to the cost of acquiring that right. Fees for services performed by third parties and loan-placement fees are recognized as revenue when all significant services have been performed. Improper practices should be criticized.

REGULATION O

The Federal Reserve's Regulation O, 12 CFR 215, governs any extension of credit, including overdrafts, by a member bank to an executive officer, director, or principal shareholder of (1) the member bank, (2) a bank holding company the member bank is a subsidiary of, and (3) any other subsidiary of that bank holding company. The regulation also applies to any extension of credit by a member bank to (1) a company controlled by such a person and (2) a political or campaign committee that benefits or is controlled by such a person. Regulation O also implements the reporting requirements for credit extensions by a member bank to its executive officers, directors, or principal shareholders or to the related interests of such persons (insiders).

Business transactions between a member bank and insiders require close supervisory review. Most of these transactions are soundly structured and have a legitimate business purpose so that all parties are treated equitably. However, absent the protection of an arm's-length transaction, the potential for or appearance of abuse is greater and requires intensified regulatory review. Examiners should pay close attention to all credit extensions of a member bank to its insiders and their related interests. The terms of the credit, particularly interest-rate and collateral terms, should not be preferential, and the credit should not involve more than a normal repayment risk. Examiners must also ensure that the amount of credit extended to an insider or a related interest, both to a single borrower and in the aggregate, conforms to the provisions of Regulation O.

A member bank's extension of credit may be considered abusive or self-serving if its terms are unfavorable to the lender, or if the credit would not have been extended on the same terms absent the official relationship. That is, it would be improbable that each party to the credit would have entered into the credit transaction under the same terms if the relationship did not exist. When a transaction appears questionable, a complete inquiry into the facts and circumstances should be undertaken so that a legal determination can be obtained. If credit extensions appear to circumvent the intent of Regulation O, they should be identified and discussed with management, and disclosed in the examination report for follow-up review and possible formal corrective action by regulatory authorities. (See Federal Reserve Regulation O for further details.)

EXAMINATION OF THE LENDING FUNCTION

Banks are expected to clearly delineate their lending objectives, policies, and procedures in writing. Lending practices are then expected to adhere to policies and procedures, with exceptions properly justified and documented. The complexity and scope of a bank's lending policy and procedures should be appropriate to the bank's size and the nature of its activities, and they should be consistent with prudent banking practices and relevant regulatory requirements.

Historically, examiners have primarily identified loan portfolio management concerns through a detailed review of credits and credit documentation. This approach remains valid, but it must be combined with a full evaluation of a bank's lending objectives, policy, and procedures. Therefore, the scope of each examination should encompass a review of the bank's lending policy and procedures and an assessment of how lending practices adhere to the policy and procedures.

When conducting a review of loan portfolio management, examiners should pay particular attention to management's approach to and handling of the following:

- monitoring of lending practices by individual lending officers
- identification of concentrations of credit
- documentation of credit and collateral exceptions
- identification of problem credits
- accounting for nonaccrual loans, renegotiated, and restructured loans
- collection of past-due loans

In addition, examiners should be aware of any evidence of self-dealing in lending transactions.

An examiner's final assessment of a bank's lending function should consider the adequacy of internal policy and procedures, the effectiveness of management oversight and control, and the overall quality of the loan portfolio. Moreover, consideration should be given to all pertinent internal and external factors, including the continuity of management, bank's historical lending experience, and current and projected economic condition for the bank's market area, particularly for any industries in which the bank has concentrations of credit.

Loan Portfolio Management
Examination Objectives
Effective date March 1984

Section 2040.2

1. To determine if policies, practices, procedures and internal controls regarding loan portfolio management are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit and loan review functions.
4. To determine the overall quality of the loan portfolio and how that quality relates to the soundness of the bank.
5. To prepare information regarding the bank's lending function in concise reportable format.
6. To determine compliance with laws and regulations.
7. To initiate corrective action when policies, practices, procedures or internal controls are deficient or when violations of law or regulations have been noted.

1. If selected for implementation, complete or update the Loan Portfolio Management section of the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining procedures.
3. Request reports on the following from the bank, by department, as of the examination date, unless otherwise specified:
   a. Past-due loans—this report should cover:
      - Single payment notes 30 days or more past maturity.
      - Single payment notes with interest due at specified intervals and demand notes on which interest is due and unpaid for 30 days or more.
      - Consumer, mortgage or term loans, payable in regular installments on which one installment is due and unpaid for 30 days or more.

      and should include the following information:
      - Name of the obligor.
      - Original amount of the loan.
      - Outstanding amount of the loan.
      - Date the loan was made.
      - Due date.
      - Terms of the loan.
      - Number of payments the loan is delinquent.
      - Date of the borrower's last payment.
      - Interest billing cycle.
      - Date up to which interest is paid.

      For larger loans, the report should also include:
      - Purpose of the loan.
      - Any action being taken.

   b. Loans in a nonaccrual status.
   c. Loans on which interest is not being collected in accordance with the terms of the loan.
   d. Loans whose terms have been modified by a reduction of interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms.
   e. Loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation or asset swap, since the previous examination.
   f. Loans acquired from another lending institution as a result of a purchase, participation or asset swap, since the previous examination.
   g. Loans considered ''problem loans'' by management. (This report may be either as of the examination date or as submitted to officer's loan review committee, loan and discount committee or board of directors.)
   h. Loan commitments and contingent liabilities.
   i. Loans secured by stock of other banks and rights, interests or powers of a savings and loan association.
   j. Extensions of credit to employees, officers, directors, principal shareholders and their interests, specifying which officers are considered executive officers.
   k. Extensions of credit to executive officers, directors, and principal shareholders and their interests, of correspondent banks.
   l. A list of correspondent banks.
   m. Miscellaneous loan debit and credit suspense accounts.
   n. Current interest rate structure.
   o. Officers' current lending authority.
   p. The nature and extent of servicing activities, including:
      - The aggregate volume and types of serviced loans.
      - The dollar volume of loans originated from out-of-territory.
      - The number of originations and sales year-to-date compared with the same period in the previous year.
      - Fee income from sales and servicing year-to-date compared with the same period in the previous year.
   q. Extenstions of credit in the form of overnight overdrafts resulting from wire transfer activities. (See the Wire Transfer section.)
4. Obtain the following information:
   a. A copy of written policies covering all lending functions.
   b. A statement of whether a standing committee administers the lending function.
   c. Copies of reports furnished to the board for meetings.

   d. Lists of directors, executive officers, principal shareholders and their interests.
   e. A summary of the officer borrowing report (debts to own and other banks).
5. Obtain a copy of the latest reports furnished to the loan and discount committee.
6. If appliable, review the lending policies and updates thereto and abstract appropriate excerpts on:
   a. Distribution of loans by category.
   b. Geographic limitations.
   c. Industrial concentration limitations.
   d. Allowable or desirable ratios of loans to other balance-sheet accounts.
   e. Lending authorities of committees and officers.
   f. Any prohibited types of loans.
   g. Maximum maturities for various types of loans.
   h. Interest rate structure.
   i. Minimum down payments for various types of loans.
   j. Collateral appraisal policies including:
      - Persons authorized to perform appraisals.
      - Lending values of various types of property.
   k. Financial information requirements by types of loans.
   l. Limitations and guidelines for purchasing and selling loans either directly, or through participations or swaps.
   m. Guidelines for supplying complete and regularly updated credit information to purchasers of loans which the bank originated.
   n. Guidelines for obtaining complete and regularly updated credit information on loans purchased from others.
   o. Guidelines for loans to major stockholders, directors, officers, or their interests.
   p. Guidelines for determining creditworthiness of any institution or customer on whose behalf the bank executes funds transfers.
7. In cases where more than one lending policy exists, determine that policies are internally consistent by reviewing the guidelines previously obtained.
8. Review minutes of the bank's loan and discount committee meetings to obtain:
   a. Present members and their attendance record.
   b. Scope of work performed.
   c. Any information deemed useful in the examination of specific loan categories or other areas of the bank.
9. Compare reports furnished to the board, the loan and discount committee and those received from the bank in step 3, to determine any material differences and that they are transmitted to the board in a timely manner.
10. Compare the lists of directors, officers, principal shareholders, and their interests to determine:
    a. Compliance with Regulation O (12 CFR 215).
    b. Preliminary compliance with established policies of the board of directors.
11. Perform the following steps for past-due loans:
    a. Compare the following to determine any material inconsistencies:
       - The past-due loan schedule received in step 3.
       - Delinquency reports submitted to the board.
       - List of loans considered ''problem'' loans by management.
       - Delinquency lists submitted for regulatory purposes.
    b. Scan the delinquency lists submitted to the board to determine that reports are sufficiently detailed to evaluate risk factors.
    c. Compile current aggregate totals of past-due paper including unplanned overdrafts not paid in 30 days.
12. Perform the following using the loan commitments and contingent liabilities schedule obtained in step 3:
    a. Reconcile appropriate contingencies totals to memorandum ledger controls.
    b. Review reconciling items for reasonableness.
13. Consult with the examiner responsible for the Asset/Liability Management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, have the examiners assigned to the various loan areas compile the information using bank records or other appropriate sources. Refer to the Instructions for the Report of Examination section of this manual for considerations to be taken into account when compiling maturity information for the GAP analysis.

14. Review the information received and perform the following for:
    a. Loan participations, loan purchases/sales, loan swaps. The procedures are designed to ensure that loan transfers involving state member banks, bank holding companies, and nonbank affiliates are carefully evaluated to determine if they were carried out to avoid classification, and to determine the effect of the transfer on the condition of the institution. In addition, the procedures are designed to ensure that the primary regulator of the other financial institution involved in the transfer is notified.
        - Check participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.
        - Ascertain whether loans are purchased on a recourse basis, and that loans are sold on a nonrecourse basis.
        - Determine that the bank does not buy back or pay interest on defaulted loans in contradiction of the underlying agreement.
        - Compare the volume of loans purchased and sold to the total portfolio.
        - Determine that the bank has sufficient expertise to properly evaluate the volume of loans purchased and sold.
        - Determine if loans are sold primarily to accommodate overline needs of customers, or to generate fee income.
        - Determine if loans are purchased or sold to affiliates or other companies in a chain banking organization; and, if so, determine that the purchasing companies are given sufficient information to properly evaluate the credit. (Section 23A of the Federal Reserve Act prohibits transfers of low-quality assets between affiliates. See the section on Bank-Related Organizations.)
        - Investigate any situations where assets were transferred prior to the date of examination to determine if any were transferred to avoid possible criticism during the examination.
        - Determine whether any of the loans transferred were nonperforming at the time of transfer, classified at the previous examination, or for any other reason were considered to be of questionable quality.
        - Review the bank's policies and procedures to determine whether or not assets or participations purchased by the bank are given an independent, complete and adequate credit evaluation. If the bank is a holding company subsidiary or a member of a chain banking organization, review asset purchases or participations from affiliates or other known members of the chain to determine if the asset purchases are given an *arm's length* and *independent* credit evaluation by the purchasing bank.
        - Determine that any assets purchased by the bank are properly reflected on its books at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such assets and an appropriate risk premium). Determine that appropriate write-offs are taken on any assets sold by the bank at less than book value.
        - Determine that transactions involving transfers of low-quality assets to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank the holding company affiliate.
        - If poor-quality assets were transferred to or from another financial institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary Federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
            — Name of originating and receiving institutions.
            — Type of assets involved and type of transfer (i.e., participation, purchase/sale, swap).
            — Date(s) of transfer.
            — Total number and dollar amount of assets transferred.
            — Status of the assets when transferred (e.g., nonperforming, classified, etc.)

- Any other information that would be helpful to the other regulator.
- The sale and purchase of U.S. government guaranteed loans and sale premiums.
  - Recommendations for Originating and Selling Institutions
    - Examiners should review the extent and nature of activities in connection with the sale of government guaranteed loans. Lax or improper management of the selling institution's servicing responsibilities should be criticized. Out-of-trade area lending for the purpose of resale of any portion of U.S. government guaranteed loans should be carefully reviewed to ensure that the practice is conducted in a safe and sound manner.
    - All income, including servicing fees and premiums charged in lieu of servicing fees, associated with the sale of U.S. government guaranteed loans, should be recognized only as earned and amortized to appropriate income accounts over the life of the loan.
  - Recommendations for Purchasing Institutions
    - Purchasers of U.S. government guaranteed loans should be aware that the purchase premiums are not guaranteed and are not paid by the guaranteeing federal agency when the loans are prepaid. Because payment of premiums which do not reasonably relate to the yield on the loan can distort published financial reports by overstating the value of a financial institution's assets, it will generally be viewed as an unsafe and unsound banking practice for a financial institution to pay purchase premiums which result in a significant overstatement in the value of bank assets.
    - Many government guaranteed loans currently being originated and sold are variable rate. These variable rate loans normally should not trade at anything more than a modest premium or discount from par. Examiners should carefully review any loans being sold or purchased at significant premiums and criticize any involvement with excessive premiums as an unsafe and unsound business practice. Excessive purchase premiums will be classified loss. The loans will be required to be revalued to the market value at the time of the acquisition and the excessive premiums will be charged against current earnings.

      In addition, any unamortized loan premium on a government guaranteed loan must be immediately charged against income if the loan is prepaid, regardless of whether payment is received from the borrower or the guaranteeing agency.

b. Loans serviced:
   - Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
   - Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
   - Ascertain whether the serviced loans are subject to a repurchase agreement or are backed by a standby letter of credit from the originating bank.
   - Compare the volume of serviced loans to the total portfolio.
   - Determine if out-of-territory originations are significant relative to loans serviced.
   - Determine if the volume of loans originated, sold and serviced is consistent with loan servicing capabilities of management.
   - Ascertain that servicing fees and premiums charged in lieu of fees are amortized over the life of the loan.

15. Obtain the listing of Uniform Review of Shared National Credits and update the listing based on information obtained in step 3.
16. Distribute the applicable schedules and other information obtained in the preceding steps to the examiners performing the loan exam-

ination procedures. Request that the examiners test the accuracy of the information. Also, request that they perform appropriate steps in the separate section, Concentration of Credits.

17. Determine general distribution characteristics of the loan portfolio by:
    a. Determining the percentage of total loans in specific classes.
    b. Comparing loan category distributions to policy guidelines.
18. Obtain the results of loan department examinations and perform the following:
    a. Determine any non-adherence to internally established policies, practices, procedures and controls.
    b. Compare the various department results to determine the extent of non-adherence and if it is systemwide.
    c. Organize internal guideline exceptions in order of relative importance.
    d. Determine the aggregate amount of statutory bad debts. (Refer to the section on dividends for a definition of statutory bad debts or ‘‘A’’ Paper.)
    e. Organize and prepare a listing of violations of law and regulations.
    f. Review loan classifications and assets listed for special mention to determine:
       - Inclusion of all necessary information.
       - Substantiation of classification.
    g. Determine the aggregate amount of paper criticized in each of the four levels of criticism.
    h. Compile a listing of all loans not supported by current and satisfactory credit information.
    i. Compile a listing of all loans not supported by complete collateral documentation.
    j. Determine the aggregate amount of out-of-area paper.
    k. Compile a listing of low-quality loans transferred to or from another lending institution through purchases/sales, participations or swaps, and submit it to Reserve Bank supervisory personnel.
    l. Review the separate procedures for ‘‘Concentration of Credits’’ and determine:
       - If all necessary data is included.
       - If there is substantiation for including specific items in the report of examination as a concentration.
       - If the concentration is undue or unwarranted.
    m. Compute the following ratios and compare to computations from prior examinations:
       - Aggregate classified paper to primary capital.
       - Weighted classified paper to primary capital.
       - Aggregate past-due paper to loans outstanding.
19. Forward the total loss and doubtful classifications, and the total of statutory bad debts (‘‘A’’ Paper) to the examiner assigned to analyze the adequacy of capital.
20. Compare management’s list of ‘‘problem’’ loans from step 3 to the listing of classified loans to determine the extent of management’s knowledge of their own loan problems.
21. Determine, through information previously generated, the causes of existing problems or weaknesses within the system which present potential for future problems.
22. Forward the following information to the examiner assigned to ‘‘Reserve for Possible Loan Losses:’’
    a. A listing of loans considered ‘‘problem loans’’ by management.
    b. A listing of classified loans.
23. Discuss results of the examination of the lending function with senior management of the bank.
24. During discussion with senior management, structure inquiries in such a manner as to:
    a. Gain insight into general management lending philosophy.
    b. Elicit management responses for correction of deficiencies.
25. Regulation O—Examination Procedures

    During the course of all examinations of the commercial activities of state member banks, examiners should determine whether the bank and its executive officers and principal shareholders have complied with the reporting and disclosure requirements of Regulation O and the appropriate statutes. Civil money penalties may be addressed for noncompliance. Specific matters which should be addressed are as follows:

    a. Reports of Examination:
       - Each report of examination of the commercial activities of state member banks should contain information as to the bank’s compliance with titles VIII and IX of FIRA as amended by the Garn Act. Violations should be

reported, as appropriate, in the following sections of the report of examination:
- — Examiner's Comments and Conclusions
- — Audit and Internal Controls
- — Violations of Law and Regulations
- — Extensions of Credit to Bank Officials

- The Garn Act eliminated the dollar limitations on mortgages and education loans to executive officers. Regulation O was amended in 1983 to raise the limitations on loans for other purposes by a member bank to its executive officers. Also, the amended Regulation O contains new provisions on the aggregate lending limit to executive officers or principal shareholders and their related interests and increased the dollar limitation on loans to insiders and their interests that require the prior approval of the bank's board of directors.

b. Schedule RC–M:
- The information from this schedule should be reviewed in connection with verifying the accuracy and completeness of the Report of Condition. Complete and accurate preparation of this schedule is particularly important because Schedule RC–M provides valuable data on possible insider abuse, and the schedule contains information that will be used in response to public requests for information concerning loans to executive officers and principal shareholders.
- Examiners should verify that the bank has established procedures for compliance with the requirements of Regulation O for disclosure of extensions of credit from itself and from correspondent banks to its executive officers and principal shareholders. The bank should maintain records of all public requests for information and the disposition of such requests.
- Records of requests for information and the disposition of such requests may be disposed of by banks after two years from the date of request.

c. Form FFIEC 004:
- Determine during examinations that each bank has notified its executive officers and principal shareholders of the reporting requirements of FIRA, has provided such officers and shareholders with a list of the bank's correspondent banks and has made available to such officers and shareholders a copy of Form FFIEC 004 (or similar form).
- During examinations, review FFIEC 004 forms (or similar forms) filed with the bank to determine that they were filed in a timely manner and that information has been reported as required.
- Information reported in box D of Form FFIEC 004 concerning terms and conditions of an extension of credit may indicate the possibility of preferential lending practices[1] at a correspondent bank. These possibilities should be referred by examiners to Reserve Banks for such additional action as may be required under the particular circumstances.
- During examinations of correspondent banks (as defined in Regulation O), loans to executive officers, directors, and principal shareholders of respondent banks should be reviewed for any evidence of preferential lending as prohibited by title VIII. Such loans should be reviewed to determine whether they were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons; involve more than normal risk (classified or specially mentioned); or have other unfavorable features, such as not being supported by adequate credit information, in violation of state lending limitations, etc.

26. Write, in appropriate report format, general remarks which may include:
    a. The scope of the examination of the lending function.
    b. The quality of internal policies, practices, procedures and controls over the lending functions.
    c. The general level of adherence to internal policies, practices, procedures and controls.

1. Preferential lending practices may constitute a violation of title VIII of FIRA, which became effective March 10, 1979.

d. The scope and adequacy of the internal loan review system.
e. The quality of the entire loan portfolio.
f. The competency of management with respect to the lending function.
g. Causes of existing problems.
h. Expectations for continued sound lending or correction of existing deficiencies.
i. Promises made by management for correction of deficiencies.
j. Loans to insiders and their interests.

27. Compile or prepare all information which provides substantiation for your general remarks.
28. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for managing the bank's loan portfolio. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

1. Has the board of directors, consistent with its duties and responsibilities, adopted written loan portfolio management policies and objectives that:
   a. Establish suggested guidelines for distribution of loans in the commercial, real estate and installment categories?
   b. Establish geographic limits for loans?
   c. Establish suggested guidelines for aggregate outstanding loans in relation to other balance sheet categories?
   d. Establish loan authority of committees and individual lending officers?
   e. Define acceptable types of loans?
   f. Establish maximum maturities for various types of loans?
   g. Establish loan pricing?
   h. Establish appraisal policy?
   i. Establish minimum financial information required at inception of credit?
   j. Establish limits and guidelines for purchasing paper?
   k. Establish guidelines for loans to bank directors, officers, principal shareholders, and their related interests?
   l. Establish collection procedures?
   m. Define the duties and responsibilities of loan officers and loan committees?
   n. Outline loan portfolio management objectives that acknowledge:
      - Concentrations of credit within specific industries?
      - The need to employ personnel with specialized knowledge and experience?
      - Community service obligations?
      - Possible conflicts of interests?
2. Are loan portfolio management policies and objectives reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are the following reported to the board of directors or its committees (indicate which) at their regular meetings (at least monthly):
   a. Past-due single payment notes (if so, indicate the minimum days past due for them to be included ________)?
   b. Notes on which interest only is past due (if so, indicate the minimum days past due for them to be included ________)?
   c. Term loans on which one installment is past due (if so, indicate the minimum days due for them to be included ________)?
   d. Total outstanding loan commitments?
   e. Loans requiring special attention?
   f. New loans and loan renewals or restructured loans?
4. Are reports submitted to the board or its committees rechecked by a designated individual for possible omissions prior to their submission?
5. Are written applications required for all loans?
6. Does the bank maintain credit files for all borrowers?
7. Does the credit file contain information on:
   a. The purpose of the loan?
   b. The planned repayment schedule?
   c. The disposition of loan proceeds?
8. Does the bank require periodic submission of financial statements by all borrowers whose loans are not fully secured by readily marketable collateral?
9. Is a tickler file maintained to ensure that current financial information is requested and received?
10. Does the bank require submission of audited financial statements based on dollar amount of commitment (if so, state the dollar minimum for requiring $________)?
11. Does the bank perform a credit investigation on proposed and existing borrowers for new loan applications?
12. Is it required that all loan commitments be in writing?
13. Are lines of credit reviewed and updated at least annually?
14. Are borrowers' outstanding liabilities checked to appropriate lines of credit prior to granting additional advances?
15. Does the bank employ a procedure for disclosure of a loan or combination of loans that are or will be secured by 25 percent of another insured financial institution's stock?

16. Does the bank employ procedures to ensure compliance with the requirements of the Lost and Stolen Securities Program (17 CFR 240.17f-l)? See Internal Control Questionnaire questions 6–15 of the Review of Regulatory Reports section and SR-79-557 for details.
17. Is there an internal review system (it may be a function of the internal audit department) which covers each department and:
    a. Rechecks interest, discount and maturity date computations?
    b. Re-examines notes for proper execution, receipt of all required supporting papers and proper disclosure forms?
    c. Determines that loan approvals are within the limits of the bank's lending authorities?
    d. Determines that notes bear the initial of the loan officer?
    e. Ascertains that new loans are within the limitations set for the borrower by corporate resolution?
    f. Rechecks the liability ledger to determine that new loans have been accurately posted?
18. Does the bank have a loan review section or the equivalent?
19. Is the loan review section independent of the lending function?
20. Are the initial results of the loan review process submitted to a person or committee which is also independent of the lending function?
21. Are all loans exceeding a certain dollar amount selected for review?
22. Do lending officers recommend loans for review?
23. Is a method, other than those detailed in steps 21 or 22, used to select loans for review (if so, provide details)?
24. Are internal reviews conducted at least annually for all lending areas?
25. In an officer identification system, are guidelines in effect which define the consequences of an officer withholding a loan from the review process?
26. Is the bank's problem loan list periodically updated by the lending officers?
27. Does the bank maintain a list of loans reviewed, indicating the date of the review and the credit rating?
28. Does the loan review section prepare summations to substantiate credit ratings, including pass loans?
29. Are loan review summations maintained in a central location or in appropriate credit files?
30. Are follow-up procedures in effect for internally classified loans, including an update memorandum to the appropriate credit file?
31. Are officers and employees prohibited from holding blank signed notes in anticipation of future borrowings?
32. Are paid and renewed notes cancelled and promptly returned to customers?
33. Are loan records retained in accordance with record retention policy and legal requirements?
34. Are new notes microfilmed daily?
35. Is a systematic and progressively stronger follow-up notice procedure utilized for delinquent loans?
36. Does the bank maintain loan interest rate schedules for various types of loans?
37. Does the bank periodically update interest rate schedules? If so, state normal frequency ________.
38. Does the bank maintain records in sufficient detail to generate the following information by type of advance:
    a. The cost of funds loaned?
    b. The cost of servicing loans, including overhead?
    c. The cost factor of probable losses?
    d. The programmed profit margin?
39. Has the bank conducted industry studies for those industries in which it is a substantial lender?
40. Are loan proceeds either credited to customers' accounts or released through issuance of official bank checks payable to the borrower?
41. Is a record of charged-off loans maintained by a person other than the one who has custody of the notes or receives payment?
    a. Is this record checked against the notes at least annually?
42. Are adequate procedures in effect with respect to recoveries?

CONCLUSION

43. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this question-

naire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

44. Based on a composite evaluation as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

A concentration of credit generally consists of direct or indirect (1) extensions of credit and (2) contingent obligations that, when aggregated, exceed 25 percent of the bank's capital structure (tier 1 capital plus the allowance for loan and lease losses). A concentration exists when the extensions of credit or other obligations possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry have been included in homogeneous risk groupings when assessing asset concentrations. Furthermore, a concentration may include the aggregate of all types of credit to or investment in a particular homogeneous risk grouping.

Limitations imposed by the various state and federal legal lending limits were intended to prevent an individual or a relatively small group from borrowing an undue amount of the bank's resources and to safeguard the bank's depositors by spreading the loans among a relatively large number of persons engaged in different businesses. However, lending limits alone are not sufficient to prevent and control concentrations of credit. Policy guidance for risk diversification should be formulated in conformity with both legal and prudent investment restrictions. Before bank management can limit the bank's involvement or perform the necessary review, it must recognize the various types of concentrations and implement systems to retrieve the information necessary to monitor and report concentrations. The Federal Reserve expects management to identify, measure, monitor, and control concentrations.

TYPES OF CREDIT CONCENTRATIONS

There are numerous possibilities for determining concentrations within a loan portfolio. In evaluating a potential concentration, it is important to determine the key factors germane to the credits. Concentrations that are commonly identified in a loan portfolio include the following:

- Loans to a group of borrowers, perhaps unrelated, predicated on the collateral support afforded by a debt or equity issue of a corporation. Regardless of whether the issuing entity is a listed concern or a closely held enterprise, a concentration may exist in the underlying collateral.
- Loans that are dependent on a particular agricultural crop or livestock herd. Banking institutions located in farming, dairying, or livestock areas may grant substantially all their loans to individuals or concerns engaged in and dependent on the agricultural industry. Concentrations of this type are commonplace and may be necessary if these banks are to adequately serve the needs of their communities.
- The aggregate amount of interim construction loans that do not have firm, permanent take-out commitments. In the event that permanent financing is not obtainable, the bank will have to continue financing the projects. This longer term financing subjects the bank to additional liquidity and possibly interest-rate risks, as well as to risks associated with the real estate itself.
- Loans to groups of borrowers who handle a product from the same industry. Although the borrowers may appear to be independent from one another, their financial conditions may be affected similarly if a slowdown occurs in their economic sector.

Concentrations may also occur in banks located in towns that are economically dominated by one or only a few business enterprises. In these situations, banks may extend a substantial amount of credit to these companies and to a large percentage of the companies' employees. If economic or other events cause the enterprise's operations to slow down or stop, heavy unemployment may result—with other job opportunities in the area limited or nonexistent.

In identifying asset concentrations, commercial and residential real estate loans can be viewed separately when their performance is not subject to similar economic or financial risks. In the same vein, commercial real estate development loans need not be grouped with residential real estate development loans, especially when the residential developer has firm, reliable purchase contracts for the sale of the homes upon their completion. Even within the commercial development and construction sector, distinctions for concentration purposes may be made, when appropriate, between those loans that have firm take-out commitments and those that do not. Groups or classes of real estate loans should, of course, be combined and viewed as concentrations when they do share significant common characteristics and are similarly affected by adverse economic, financial, or business developments.

IDENTIFYING LOAN CONCENTRATIONS

The examiner should understand and evaluate the effectiveness of the internal policies, systems, and controls that an institution uses to monitor and manage the risk associated with asset concentrations. Every institution should maintain adequate records that may be used to identify asset concentrations. The degree of sophistication of the reporting records will vary by the size of institution. For example, larger institutions may have the automated capability to segregate loans by Standard Industrial Classification (SIC) codes, while smaller institutions may generate asset concentration listings manually.

Regardless of the identification system used by the institution, the accuracy of listed concentrations, as well as the appropriateness of concentrations, should be verified during the examination. All new and any existing asset concentrations should be reported monthly to the institution's board of directors or other appropriate committee for review.

RISK MANAGEMENT OF ASSET CONCENTRATIONS

Institutions with asset concentrations are expected to have in place effective policies, systems, and internal controls to monitor and manage this risk. The bank's board of directors is responsible for establishing appropriate risk parameters and for monitoring exposure, as well as for evaluating the methods used by management to manage and control concentration risk. Furthermore, the Board's Regulation F addresses exposure that may arise from a bank's relationship with its correspondents. Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. Banking organizations with a need to reduce asset concentrations are normally expected to develop a plan that is realistic, prudent, and achievable in view of their particular circumstances and market conditions.

The purpose of an institution's policies should be to improve the overall quality of its portfolio. Institutions that have effective internal controls to manage and reduce excessive concentrations over a reasonable period of time need not automatically refuse credit to sound borrowers because of their particular industry or geographic location. Furthermore, a bank may be able to reduce the risks associated with concentrations through the strengthening of individual credits. For example, the bank may be able to obtain additional collateral or guarantees. In the event of deterioration, the bank's position would be improved because the additional collateral or guarantees provide a cushion against losses.

When concentration levels have been built up over an extended period, it may take time, in some cases several years, to achieve a more balanced and diversified portfolio mix. Given the institution's trade area, lack of economic diversity, or geographic location, reducing the existing concentration in the near term may be impossible. If a concentration does exist, the banking organization should have adequate systems and controls for reducing undue or excessive concentrations in accordance with a prudent plan. Strong credit policies and loan administration standards should provide adequate control for the risks associated with new loans. The institution should also maintain adequate capital to protect the institution while its portfolio is being restructured. For identified asset concentrations, bank management should be aware of not only the particular company's or industry's recent trends, but also of its future prospects.

Alternatives for Reducing Concentrations

Some alternatives for institutions whose asset concentrations are not likely to be reduced in the near term are described below.

Increased Holdings of Capital

To compensate for the additional risk that may be associated with an asset concentration, a bank may elect to maintain a higher capital ratio than would be required under the risk-based capital guidelines. This additional capital would provide support in the event the concentration adversely affects the organization's financial position.

Increased Allowance for Loan and Lease Losses

The banking organization may choose to factor a cushion for loan concentrations into its determination of an adequate allowance for loan and lease losses a basis-point cushion for loan concentrations in determining the minimum level. This cushion would be available to absorb some deterioration in loan concentrations.

Loan Participations

If a banking institution has a concentration, it may be possible to sell a portion of the loan portfolio in the secondary market to reduce its dependency on an asset group. If the institution is not large enough to participate in the secondary market, an alternative might be to sell loans, without recourse, to a correspondent bank that is also attempting to diversify its loan portfolio.

Government Guarantee Programs

Another possible solution to reduce the risk associated with a loan concentration is to seek government guarantees of originated loans. In some cases, a government agency may be willing to guarantee (or insure) a portion of agricultural or small-business loans, thereby reducing the risk to the originating bank.

Concentrations of Credit
Examination Objectives
Effective date May 1996

Section 2050.2

1. To determine if the policies, practices, procedures, and internal controls regarding concentrations of credit are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the existence of any concentrations of credit.
4. To determine if any concentrations of credit represent a hazard to the soundness of the bank.
5. To determine that concentrations of credit do not violate applicable banking statutes.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient.

Examiners should obtain or prepare the information necessary to perform the appropriate procedural steps.

1. If selected for implementation, complete or update the Concentrations of Credits section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.
4. Request the bank's schedules of concentrations that are reported to the board of directors and/or senior management at regular intervals and—
   a. if schedules are not current, update and/or have bank personnel update them as of the examination date and
   b. request that other examiners review the schedules for reasonableness relative to information developed in performing the examination procedures for the various departments.
5. If schedules of concentrations are not maintained or if the listing is incomplete, prepare or obtain the following schedules of obligations that exceed 25 percent of the bank's capital structure—
   a. loans collateralized by a common security
   b. loans, contingent liabilities, and/or other obligations to one borrower or a related group of borrowers
   c. loans dependent upon a particular crop or herd
   d. aggregate loans to major employers in the service area, their employees, and their major suppliers
   e. loans within industry groups
   f. out-of-normal territory loans
   g. all construction or development loans without firm takeout commitments.
6. If the schedules were prepared by others, review them for reasonableness relative to information developed in performing the examination procedures for the various loan areas.
7. Obtain a listing of due from bank accounts.
8. Obtain from the examiner assigned "Investment Securities" the schedule of investments and money market instruments that exceed 10 percent of the bank's capital structure.
9. Combine the schedules obtained in steps 4 through 8 and determine concentrations that equal or exceed 25 percent of the bank's capital structure. The remaining procedures apply only to these concentrations.
10. From the schedule of loans collateraled by a common security, eliminate all borrowers for whom the common security can be considered excess collateral, then review—
    a. the trend in market prices and
    b. current financial information, if appropriate.
11. For loans dependent upon a particular crop or herd—
    a. review the bank's files for information on market conditions, future markets, and estimated prices and
    b. determine any adverse trends that might affect payment of the concentrations.
12. For loans dependent upon major employers—
    a. review financial and other available information on the company and evaluate its ability to continue as an ongoing entity,
    b. review excerpts from trade papers or periodicals in bank files to determine that bank management is adequately informed on the business activity of the company, and
    c. note any adverse trends that might affect the collectibility of the loans in the concentrations.
13. For loans within industry groups—
    a. review financial and other available information on each industry and evaluate its ability to continue as a viable industry,
    b. review the bank's files to determine that management is adequately informed on the activities of the industry, and
    c. determine any adverse trends that might affect the collectibility of the loans included in the concentrations.
14. For due from bank accounts, inquire as to the reasonableness of the account relative to the activity and services provided.
15. Discuss with management—

   a. the adequacy of written policies regarding concentrations of credit,
   b. the manner in which the bank's officers are operating in conformance with established policies,
   c. concentrations that will appear in the report of examination, and
   d. any matter requiring immediate attention.
16. Prepare, in appropriate form, all information regarding concentrations for inclusion in the report of examination. A comment should be made regarding each concentration, particularly regarding the percentage of the bank's capital accounts (total capital) that the total of each concentration represents. Examiners should avoid direct requests for reduction in the concentration unless facts are included that would support this action.
17. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures relating to concentrations of credit. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

POLICIES

1. Has a policy been adopted that specifically addresses concentrations of credits?
2. Does the policy include deposits and other financial transactions with financial institutions?
3. Have controls been instituted to monitor the following types of concentrations:
   a. loans and other obligations of one borrower
   b. loans predicated on the collateral support afforded by a debt or equity issue of a corporation
   c. loans to a company dominant in the local economy, its employees, and major suppliers
   d. loans dependent upon one crop or herd
   e. loans dependent upon one industry group
   f. loans considered out of normal territory
4. Are periodic reports of concentrations required to be submitted to the board or its committee for review (if so, state frequency ________)?
5. Are the periodic reports checked for accuracy by someone other than the preparer before being submitted to the board or its committee?
6. When concentrations exist predicated upon a particular crop or herd of livestock, does the bank attempt to diversify the inherent potential risk by means of—
   a. participations or
   b. arrangements with governmental agencies such as—
      - guarantees or
      - lending arrangements?
7. When concentrations exist predicated upon a particular industry, does the bank make a periodic review of industry trends?

CONCLUSION

8. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
9. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).